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# TRANSCRIPT OF RECORD

## SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1930

No. 288

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

THOMPSON OIL & GAS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR CERTIORARI FILED JULY 11, 1930
CERTIORARI GRANTED OCTOBER 13, 1930

(35210)

# SUPREME COURT OF THE UNITED STATES

## OCTOBER TERM, 1930

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## DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

## THOMPSON OIL & GAS COMPANY

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

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A

[Caption omitted.]

1 Before United States Board of Tax Appeals

Docket No. 10600

THOMPSON OIL AND GAS COMPANY, TULSA, OKLAHOMA

vs.

COMMISSIONER OF INTERNAL REVENUE

For taxpayer, Phil Morelock, Esq.; for commissioner, A. H. Fast, Esq. Mr. Trammell (member). 5-26-28.

*Docket entries*

1926

Jan. 4—Petition received and filed.
Jan. 11—Copy of petition served on solicitor.
Jan. 11—Notification of receipt mailed taxpayer.
Feb. 10—Answer filed by solicitor.
Feb. 15—Copy of answer served on taxpayer; assigned to field calendar.

1927

July 20—Motion to amend petition filed by taxpayer; amendment tendered.
July 22—Granted; both sides notified.
July 25—Copy of motion served on G. C.
July 22—Hearing set Oct. 27, 1927, Kansas City.
Sept. 13—Hearing date advanced to 10-14-27 at Kansas City.
Sept. 22—Motion, extension 9-23 to 10-23, to answer, filed by G. C.
Sept. 23—Granted; both sides notified.
Sept. 13—Answer to amend petition filed in field by G. C.
Oct. 14—Hearing had before Mr. Lansdon on merits; stipulation of facts filed; briefs due 11-13-27.
Nov. 14—Motion, for an extension to 12-10-27 to file brief, filed by G. C.
Nov. 15—Granted; both sides notified.
Dec. 3—Motion, for an extension to 1-14-28 to file brief, filed by taxpayer.
Dec. 5—Granted.
Dec. 9—Brief filed by G. C.

1928

Jan. 12—Brief filed by taxpayer.

1929

Mar. 20—Findings of fact and opinion rendered, Mr. Littleton. Judgment will be entered for the respondent.
2 Mar. 21—Decision entered.
Aug. 29—Motion to fix amount of bond filed by taxpayer ($29,838.44).

1929

Aug. 29—Motion to fix amount of bond granted.
Sept. 5—Petition for review by U. S. Cir. Ct. of Ap. (10), with assignments of error, filed by taxpayer.
Sept. 5—Proof of service filed.
Nov. 1—Agreed præcipe filed.
Nov. 1—Stipulation, as to time for certification of record enlarged to 11-19-29, filed.

Now, November 6, 1929, the foregoing docket entries certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

Before United States Board of Tax Appeals

[Title omitted.]

*Petition*

Filed Jan. 4, 1926

The above-named taxpayer hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his deficiency letter (IT:E:SM-60D GM-16670, A-16689) dated November 14, 1925, and as the basis of its appeal sets forth the following:

JURISDICTION OF THE BOARD

1. The taxpayer is an Oklahoma corporation, with its principal office at Tulsa, Oklahoma.

2. The deficiency letter (copy of which is attached) was mailed to the taxpayer on November 14, 1925, and states a deficiency of $29,838.44.

3. The taxes in controversy are income and profits taxes for the calendar year 1918 and are less than $10,000, to wit, $6,824.59.

ASSIGNMENTS OF ERROR

4. The determination of tax contained in the said deficiency letter is based upon the following errors:

3 (a) The Commissioner of Internal Revenue has computed the profits tax for the calendar year 1918 under the provisions of section 328 of the revenue act of 1918 as 47.5% of the statutory net income, said profits tax amounting to $27,470.11 whereas it is thought that the rate of excess profits tax should be between 35% and 40% of said statutory net income, or approximately $23,101.62.

(b) A list of competitors has been submitted for use as comparatives, but it is not known whether such list was considered in the computation of the profits tax by the commissioner. Furthermore, the commissioner has not disclosed the comparative data upon which he has based the computation of the profits tax.

STATEMENT OF FACTS

5. The corporation is engaged in the production of oil. The statutory invested capital of the corporation could not be determined satisfactorily, and the commissioner has passed favorably upon the application of the corporation under the provisions of section 327 of the revenue act of 1918 for the computation of its profits taxes for the year 1918 under the provisions of section 328 of the revenue act of 1918. The statutory net income agreed upon amounted to $57,754.06. The profits tax as computed by the commissioner amounts to $27,470.11, or 47.5% of the agreed statutory net income.

PROPOSITION OF LAW

6. The taxpayer in support of its appeal relies upon the following proposition of law: Section 328 of the revenue act of 1918.

Wherefore the taxpayer respectfully prays that this board may hear and determine its appeal.

PHIL D. MORELOCK,
*Of Shouse, Doolittle & Morelock,*
*710 Land Bank Building, Kansas City, Missouri,*
*Counsel for Taxpayer.*

[*Duly sworn to by A. F. Bourne; jurat omitted in printing.*]

4 *Deficiency letter*

TREASURY DEPARTMENT,
*Washington, Nov. 14, 1925.*

IT:E:SM-60D, GM-16670, A-16689.
THOMPSON OIL & GAS COMPANY,
*P. O. Box 463, Tulsa, Oklahoma.*

SIRS: An audit of your income and profits tax returns for the calendar years 1917 and 1918 has resulted in the determination of a deficiency in tax of $29,838.44 for the year 1918 and an overassessment of $1,786.70 for the year 1917, as shown in the attached statement.

In accordance with the provisions of section 274 of the revenue act of 1924 you are allowed 60 days from the date of mailing of this letter within which to file an appeal to the United States Board of Tax Appeals contesting in whole or in part the correctness of this determination.

Where a taxpayer has been given an opportunity to appeal to the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement in respect of any part of the deficiency will be entertained.

If you acquiesce in this determination and do not desire to file an appeal, you are requested to sign the inclosed agreement consenting

to the assessment of the deficiency and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:E:SM-60D, GM-16670, A-16690. In the event that you acquiesce in a part of the determination the agreement should be executed with respect to the items agreed to.

Respectfully,

D. H. BLAIR,
*Commissioner.*

By ——— ———,
*Assistant to the Commissioner.*

*Statement*

IT:E: SM-60D, GM-16670, A-16690.

In re Thompson Oil & Gas Company, P. O. Box 463, Tulsa, Oklahoma

| | Deficiency in tax | Overassessment |
|---|---|---|
| 1917 | | $1,786.70 |
| 1918 | $29,838.44 | |

After a careful review of your protest dated June 27, 1925, against the result of the allowance of your application for assessment of your profits tax under the provisions of sections 210 and 328 of the revenue acts of 1917 and 1918, respectively, as set forth in bureau letter dated June 15, 1925, and of all the evidence submitted in support of your contentions at the conference held September 9, 1925, you are advised that the bureau holds that the profits tax as shown in the above-mentioned letter is representative of the rate of profits tax paid by concerns engaged in a like or similar trade or business and affords adequate relief under the provisions of sections 210 and 328 of the revenue acts of 1917 and 1918, respectively.

The deficiency in tax of $29,838.44 for 1918 and the overassessment of $1,786.70 for 1917, of which you were advised in bureau letter dated June 15, 1925, are therefore sustained.

A copy of this letter is being furnished your representatives, Shouse, Doolittle & Morelock, 710 Land Bank Building, Kansas City, Missouri, in accordance with the authority conferred by your company.

The right of appeal to the United States Board of Tax Appeals, as indicated on page one of this letter, refers only to any deficiency in tax indicated herein, inasmuch as there is no provision in the revenue act of 1924 granting the right of appeal against the determination of any overassessment found upon an audit of your returns.

6 Now, November 6, 1929, the foregoing petition certified from the record as a true copy.

B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

Before United States Board of Tax Appeals

*Answer*

Filed Feb. 10, 1926

Comes now the Commissioner of Internal Revenue, by his attorney, A. W. Gregg, Solicitor of Internal Revenue, and for answer to the petition filed in the above-entitled appeal admits and denies as follows:

1. Admits the statements contained in paragraphs 1, 2, and 3 of the petition.

2. Admits the statement of fact contained in paragraph 5.

PROPOSITION OF LAW

1. The taxpayer is not entitled to any other or further relief in the computation of its profits taxes than has been determined by the commissioner.

Wherefore it is prayed that the taxpayer's petition be dismissed and the appeal denied.

A. W. GREGG,
*Solicitor of Internal Revenue,*
*Attorney for Commissioner of Internal Revenue.*

Of counsel:
WARD LOVELESS,
*Special Attorney, Bureau of Internal Revenue.*

Now, November 6, 1929, the foregoing answer certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

Before United States Board of Tax Appeals

*Amended petition*

The above-named petitioner hereby admits for the consideration of the board in the determination of this cause the following amended petition:

1. The petitioner is an Oklahoma corporation with its principal office at Tulsa, Oklahoma.

7 2. The deficiency letter (copy of which was attached to the original petition) was mailed to the petitioner on November 14, 1925, and stated a deficiency of $29,838.44.

3. The taxes in controversy are income and profits taxes for the calendar year 1918 and are for $5,010.63.

4. The determination of the tax contained in the said deficiency letter is based upon the following errors:

(a) The Commissioner of Internal Revenue has added the cost of lease, amounting to $30,000, in 1916, and has also added 300,000 barrels to the reserves of oil in 1916, whereas the commissioner should have added the 300,000 barrels of oil to the March 1, 1913, reserves as computed and then added the $30,000 paid for renewal of the lease in 1916.

(b) The Commissioner of Internal Revenue has reduced the March 1, 1913, value by depletion sustained from 1913 to 1916, inclusive, whereas under the law laid down by the Supreme Court in the case of U. S. v. Ludey the March 1, 1913, value should have been reduced only by the depletion allowed as a deduction from income under the 1913 and 1916 revenue acts, amounting to 5% of the gross sales of oil.

5. The facts upon which the amended petition are based follow:

(a) The petitioner operates the lease known as the Bessie and Fillie Clayton lease, SW. ¼ of SW. ¼ of section 4, township 17 north, range 12 east, in the Glenn Pool district. The original lease was acquired on August 16, 1907, and by its terms expired August 6, 1918. Contract for renewal of the lease was entered into July 15, 1916. The renewal price was $30,000. The contract of 1916 renewing the lease as at August 6, 1918, provided for ⅛ royalty instead of ⅛, as provided by the terms of the former leases.

(b) The following schedules are submitted:

1. Schedule A, showing computation of depletion by commissioner.

2. Schedule A–1, showing schedule computed by the commissioner adjusted to show depletion allowable under the 1913 and 1916 laws as provided by the Supreme Court in the case of U. S. v. Ludey.

3. Schedule B, showing the addition of $300,000 barrels reserves in 1913 and the addition of $30,000 renewal price of lease in 1916.

8 4. Schedule B–1, adjusting of Schedule B in accordance with the decision of the Supreme Court in the case of U. S. v. Ludey.

5. Schedule C, gross income and depletion deductible under the law for the years 1913 to 1916, inclusive.

Wherefore the petitioner prays that the board may hear this proceeding and grant relief as follows:

The allowance as deduction from income in 1918 of depletion in the amount of $16,056.21.

PHIL D. MORELOCK,
*Counsel for Petitioner.*

[*Duly sworn to by A. F. Bourne; jurat omitted in printing.*]

9 SCHEDULE A.—*Depletion schedule—March 1, 1913, value and subsequent cost*

| Year | Capital sum | | | Reserves | | Production | Depletion unit | Depletion sustained |
|---|---|---|---|---|---|---|---|---|
| | Beginning | Added | Total | Added | Total | | | |
| 3-1-13 to 12-31-15 | | | 156,645.00 | | 278,000 | 162,717 | .56347 | 91,686.15 |
| 1916 | 64,958.85 | 30,000.00 | 94,958.85 | 300,000 | 415,283 | 49,452 | .22866 | 11,307.09 |
| 1917 | 83,651.16 | | | | 365,831 | 39,204 | | 8,964.39 |
| 1918 | 74,686.77 | | | | 326,627 | 33,097 | | 7,705.16 |

Copy of Treasury Department Schedule dated 6-3-24 (IT : En : OG : VHS).

10 SCHEDULE A-1.—*Depletion schedule—March 1, 1913, value and subsequent cost*

| Year | Capital sum | | | Reserves | | Production | Depletion unit | Depletion | |
|---|---|---|---|---|---|---|---|---|---|
| | Beginning | Added | Total | Added | Total | | | Sustained | Deductible |
| 3-1-13 to 12-31-15 | | | 156,645.00 | | 278,000 | 162,717 | .56347 | 91,686.15 | 9,262.29 |
| 1916 | | 30,000.00 | | 300,000 | 415,283 | 49,452 | .22866 | 11,307.09 | 3,034.46 |
| 1917 | [1] 174,328.25 | | 174,328.25 | | 365,831 | 39,204 | .4765 | 18,680.71 | |
| 1918 | | | 155,647.54 | | 326,627 | 33,097 | | 16,056.21 | |

[1] Capital sum beginning 1917 reduced only by depletion deductible.

11 SCHEDULE B.—*Depletion schedule—March 1, 1913, value and subsequent cost*

| Year | Capital sum | | | Reserves | | Production | Depletion unit | Depletion sustained |
|---|---|---|---|---|---|---|---|---|
| | Beginning | Added | Total | Added | Total | | | |
| 3-1-13 to 12-31-15 | | | 156,645.00 | | 578,000 | 162,717 | .271 | 44,096.31 |
| 1916 | 112,548.69 | 30,000.00 | 142,548.69 | | 415,283 | 49,452 | .3432 | 16,971.93 |
| 1917 | | | 125,576.76 | | 365,831 | 39,204 | | 13,454.81 |
| 1918 | | | 112,121.95 | | 326,627 | 33,097 | | 11,564.81 |

12 SCHEDULE B-1.—*Depletion schedule—March 1, 1913, value and subsequent cost*

| Year | Capital sum | | | Reserves | | Production | Depletion unit | Depletion | |
|---|---|---|---|---|---|---|---|---|---|
| | Beginning | Added | Total | Added | Total | | | Sustained | Deductible |
| 3-1-13 to 12-31-15 | | | 156,645.00 | | 578,000 | 162,717 | .271 | 44,096.31 | 9,262.29 |
| 1916 | | 30,000.00 | | | 415,283 | 49,452 | .3432 | 16,971.93 | 3,034.46 |
| 1917 | [1] 174,328.25 | | 174,328.25 | | 365,831 | 39,204 | .4765 | 18,680.71 | 18,680.71 |
| 1918 | | | 155,647.54 | | | 33,097 | | 16,056.21 | 16,056.21 |

[1] Capital sum beginning 1912 reduced only by depletion deductible.

18 SCHEDULE C.—*Gross income and depletion, 1913 to 1916, inc.*

| Years | Production (bbls.) | Gross income | Depletion | |
|---|---|---|---|---|
| | | | Sustained | Deductible[1] |
| 1913 (10 mo.) | 113,393.37 | 102,278.18 | 91,686.15 | 5,139.09 |
| 1914 | 60,599.00 | 47,883.26 | | 2,394.16 |
| 1915 | 60,667.00 | 34,580.89 | | 1,729.04 |
| 1916 | 48,150.00 | 60,589.26 | 11,307.69 | 3,094.46 |

[1] Depletion deductible represents 5% of gross income.

Now, November 6, 1929, the foregoing amended petition certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

## Before United States Board of Tax Appeals

### *Answer to amended petition*

The Commissioner of Internal Revenue, by his attorney, A. W. Gregg, General Counsel, Bureau of Internal Revenue, for answer to the amended petition of the above-named taxpayers admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.
2. Admits the allegations contained in paragraph 2 of the petition.
3. Admits the allegations contained in paragraph 3 of the petition.
4. Admits only that the adjustments were made, but denies that any error was made as therein alleged.
5. Admits the allegations of subparagraph (a) of paragraph 5 of the petition and that the facts stated in subparagraph (b) of said paragraph and further designated as Schedule A are true, but denies the correctness of the remaining schedules referred to in said paragraph.

Denies each and every other material allegation of fact contained in the petition.

14 Wherefore it is prayed that the taxpayer's appeal be denied.

A. W. GREGG,
*General Counsel, Bureau of Internal Revenue.*

Of counsel:
J. G. GIBBS,
*Special Attorney, Bureau of Internal Revenue.*

Now, November 6, 1929, the foregoing answer to amended petition certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

## Before United States Board of Tax Appeals

*Findings of fact and opinion*

**Promulgated March 20, 1929**

In determining the depletion allowance deductible for 1918, under the provisions of section 234 (a) (9) of the revenue act of 1918, on account of a leasehold for the extraction of oil, which was acquired prior to March 1, 1913, and under which operations were carried on from March 1, 1913, to 1918, consideration should be given to the entire exhaustion sustained for all years, regardless of whether the whole amount of such exhaustion has been allowable as a deduction from gross income for income-tax purposes for such prior years. United States v. Ludey (274 U. S. 295) distinguished.

Phil D. Morelock, Esq., for the petitioner.

Arthur H. Fast, Esq., for the respondent.

The commissioner determined a deficiency in income and profits tax for the calendar year 1918 in the amount of $29,838.44. The issue involves the question of the correct basis for the computation of the deduction allowable from gross income for 1918 on account of depletion of oil land held and operated by the petitioner under a lease contract. The facts are stipulated.

### FINDINGS OF FACT

Petitioner is an Oklahoma corporation, with its principal office at Tulsa. Prior to March 1, 1913, it acquired an oil and gas mining lease on the southwest quarter (SW. ¼) of the southwest quarter (SW. ¼) of section four (4), township seventeen (17) north, range 12 east, in Creek County, Oklahoma. The lease was an assignment of portion of a lease entered into on December 5, 1906, between Charlie Clayton, guardian of Bessie Blayton, and William McKinley Clayton, minors, as lessor, and the Indiahoma Oil Company, a corporation, as lessee, and by its terms was to expire on August 6, 1918. Under it petitioner acquired a seven-eighths (⅞) working interest, and the lessor retained a one-eighth (⅛) royalty interest.

15. July 15, 1916, an agreement in writing was entered into between P. B. France, guardian of Bessie Clayton and William McKinley Clayton, minors, as party of the first part, and the petitioner, as party of the second part, wherein, for a consideration of $30,000 paid by petitioner, the original lease was altered in that it was "extended so as to provide, in addition to the other provisions therein, that said lease shall extend and be and remain in force" on said land "until August 6, 1918, as provided in the original lease and as long thereafter as oil and gas is produced * * * in paying quantities." Also the royalty rate was changed from one-eighth to one-sixth, effective July 1, 1916.

Petitioner's oil reserve at March 1, 1913, to be recovered under the lease of December 5, 1906, prior to its termination on August

6, 1918, was 278,000 barrels, and the March 1, 1913, value of such recoverable reserve, including the value of physical equipment then on the property, was $176,645. Of this value $20,000 represented the value of the equipment and $156,645 represented the value returnable through depletion. The increase in the petitioner's ultimate recoverable oil reserve by reason of the agreement of July 15, 1916, was 300,000 barrels.

In determining the depletion allowances for the petitioner the commissioner prepared a depletion schedule wherein he used the March 1, 1913, value of $156,645, and a recoverable reserve as of March 1, 1913, of 278,000 barrels. This resulted in a depletion unit of $.56347 per barrel for the years 1913, 1914, and 1915. To obtain the remaining March 1, 1913, value to be recovered at the beginning of each succeeding year, the commissioner reduced the original March 1, 1913, value each year by the depletion actually sustained on the basis of the reserve and value established. In 1916 the commissioner added into the schedule the $30,000 consideration paid in connection with the extension of the above lease and simultaneously added the 300,000 barrels by which the petitioner's oil reserve was increased under said agreement.

The petitioner's production in barrels, its gross income, 5 per cent of the gross income, and the depletion sustained, for the years 1913, 1914, and 1915, were as follows:

| Year | Production (barrels) | Gross income | 5% of gross income | Depletion sustained |
|---|---|---|---|---|
| 1913 (10 mos.) | 45,808.38 | $44,805.00 | $2,244.78 | $91,686.15 |
| 1914 | 61,343.53 | 48,450.00 | 2,422.50 | |
| 1915 | 55,565.12 | 33,095.44 | 1,654.77 | |
| | 162,717.03 | 126,440.44 | 6,322.02 | |

16 The following schedule was prepared by the commissioner in determining the depletion allowance for 1918:

CAPITAL SUM

| Year | Beginning of year | Added during year | Total for year |
|---|---|---|---|
| 3-1-13 to 12-31-15 | $156,645.00 | | $156,645.00 |
| 1916 | 64,958.85 | $30,000 | 94,958.85 |
| 1917 | 83,651.16 | | |
| 1918 | 74,686.77 | | |

RESERVES (BARRELS)

| Added during year | Total for year | Production (barrels) | Unit cost | Depletion sustained |
|---|---|---|---|---|
| 278,000 | 278,000 | 162,717 | $.56347 | $91,686.15 |
| 300,000 | 415,283 | 49,452 | .22866 | 11,307.69 |
| | 365,831 | 30,204 | | 8,964.30 |
| | 326,627 | 33,607 | | 7,705.16 |

OPINION

LITTLETON. The issue concerns the proper basis for computing the deduction from gross income allowable for the year 1918 on account of depletion of oil land operated by the petitioner under a lease contract.

The revenue act of 1918 provides in material part as follows:

"SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions

* * * * * * *

"(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: Provided, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: * * *"

17 The controversy arises as the result of a limitation in the revenue act of 1913 with respect to the depletion allowable as a deduction from gross income for income-tax purposes. A part of the stipulation which we did not incorporate in our findings is this statement: "For the years 1913, 1914, and 1915, which were taxed under the 1913 act, the depletion allowance could not exceed '5 per centum of the gross value at the mine of the output for the year for which the computation is made.'" It is further shown that 5 per cent of the gross income from March 1, 1913, to December 31, 1915, was $6,322.02, whereas the depletion sustained for this period was $91,686.15, and the argument presented by both parties proceeds on the theory that the depletion allowable as a deduction from March 1, 1913, to December 31, 1915, was $6,322.02. Our consideration of the issue presented will, accordingly, be based on this agreement of the parties that the depletion allowable to the petitioner as a deduction from gross income from March 1, 1913, to December 31, 1915, was $6,322.02, whereas the depletion sustained during this period on the March 1, 1913, value was $91,686.16.

When the commissioner came to determine the depletion allowance for the year 1918, he took the March 1, 1913, value of the recoverable oil reserve at March 1, 1913, $156,645, and the oil reserve at this time of 278,000 barrels as a starting point. From this he determined a depletion unit of 56.347 cents per barrel. The production from March 1, 1913, to December 31, 1915, was 162,717 barrels, or a reduction in the March 1, 1913, value of the oil reserve of $91,686.15. In 1916 there was an additional cost of $30,000 and an addition to the oil reserve of 300,000 barrels. On account of this additional cost and the addition to the oil reserve, the commissioner found it necessary to determine a new depletion unit on the basis of the oil yet to be recovered in 1916, the March 1, 1913, value which remained un-

depleted at this time and the additions which were made at this time in cost and in the quantity of oil to be recovered. The value to be recovered in 1916 was determined by deducting from the March 1, 1913, value of $156,645 the depletion sustained from March 1, 1913, to December 31, 1915, $91,686.15, and adding to this remainder the additional cost in 1916 of $30,000, which showed a capital sum yet to be recovered of $94,958.85. The recoverable oil in 1916 was similarly determined; that is, from the oil reserve in 1913, 278,000 barrels, was deducted the oil produced from March 1, 1913, to December 31, 1915, 162,717 barrels, and to this remainder was added the addition to the oil reserve in 1916 of 300,000 barrels, which showed oil yet to be recovered in the amount of 415,283 barrels. The
18 depletion unit was then arrived at by dividing the remaining recoverable value by the remaining recoverable oil, which produced a unit of 22.866 cents per barrel. No additions are shown to cost or the oil reserve from 1916 to 1918. To obtain the allowance for depletion sustained for 1916, 1917, and 1918, the production in each of those years was multiplied by the depletion unit of 22.866 cents shown above; that is, for 1918 the depletion allowance determined and allowed by the commissioner was $7,705.16, which was obtained by multiplying the oil produced in 1918, 33,697 barrels, by the depletion unit of 22.866 cents.

The precise and specific question raised on account of the foregoing allowance is whether, in determining the depletion unit applicable to the year 1918, the action of the commissioner was correct in reducing the recoverable leasehold value by the depletion sustained from March 1, 1913, to December 31, 1915, or whether, as the petitioner contends, such recoverable value should be reduced only by the depletion which the parties have agreed the petitioner was entitled to take as a deduction from gross income in its income-tax returns for those years. At the outset it should be observed that no particular method is outlined for determining the depletion allowance under section 234 (a) (9), supra, the controlling principle being that it shall be reasonable, nor are we interested in the means by which this end is accomplished. Our questions then are: Did the commissioner determine a reasonable allowance? And, if not, will such result be obtained by following the petitioner's contention?

That a reasonable allowance for the depletion of a wasting or exhaustible asset, such as we have here, will be obtained by considering that the recoverable value will become exhausted in the same ratio as that which gives value to the asset disappears can hardly be questioned. (Lynch v. Alworth-Stephens Co., 267 U. S. 364.) For example, if at January 1, 1917, a taxpayer had purchased a leasehold for the recovery of oil at a cost of $100,000 with oil to be recovered of 400,000 barrels, and if, during 1918, 100,000 barrels had been produced, a depletion allowance of $25,000, or 25 cents per barrel, would certainly be accepted as the reasonable depletion allowance for 1918. Nor do we understand that the petitioner would deny that the foregoing result is in full compliance with the statute, pro-

vided the full exhaustion in 1917 was likewise deductible. But the petitioner, in effect, says that the foregoing method would not be correct if there had been a limitation in a statute applicable to 19 1917 on account of which the full depletion sustained for 1917 had not been allowable as a deduction from gross income for 1917, and, it seems to us, contends further that whatever depletion was sustained in the prior year which was not allowable as a deduction from gross income in such year should effectually be allowed as a part of the depletion deductions in later years to the end that when the asset is finally depleted its full capital value may have been allowed as deductions from gross income. We find nothing in the statute which justifies this conclusion. What the statute provides for is a reasonable allowance, and we can not interpret this to mean more than a reasonable allowance based upon the exhaustion which occurred during a given year. To follow the petitioner's theory would be to say that the exhaustion which occurred from March 1, 1913, to December 31, 1915, of approximately $85,000, which, the parties have agreed, was not an allowable deduction in those years, should be added to deductions which are allowable on account of exhaustion which occurred in later years. This theory is unsound. It may well be that under the limitations set out in the 1913 act the full capital cost or March 1, 1913, value will never be recovered as a deduction in the form of a depletion allowance, but a limitation was expressly provided by the 1913 act and its constitutionality has been upheld. (Stanton v. Baltic Mining Co., 240 U. S. 103.) We find nothing in the 1918 act, under which we are making our determination in this case, which would permit a greater depletion allowance in a given year than that based on the exhaustion which occurred in such year. When exhaustion of the capital value occurred from March 1, 1913, to December 31, 1915, of $91,686.15 and the petitioner was entitled to deduct only $6,322.02 of this amount, the excess which the petitioner was not entitled to deduct had as truly disappeared from the capital value as if it had been allowed as a deduction.

Nor can we agree that the case of United States v. Ludey (274 U. S. 295), on which the petitioner relies, supports its position. That case involved the gain or loss on the sale of capital assets under the revenue act of 1917 and had for one of its questions the adjustment which should be made to cost, or the March 1, 1913, value on account of depreciation and depletion from date of acquisition, or March 1, 1913, to the date when the assets were disposed of. The court held that:

"* * * Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years."

20 This decision, however, related to an entirely different section of the statute from that which we are now considering. Here we are concerned with the reasonable allowance for depletion in a given year, and not with the gain which may be realized

or loss sustained when the asset is ultimately disposed of. It is true that the court made the following statement in the Ludey case with respect to the theory of depletion:

"The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operating is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. * * *"

But this statement of the court can not be interpreted as meaning that because there was a gradual sale in one year, in the form of depletion sustained which is a proper charge against manufacturing operations for such year, a part of such depletion allowance is chargeable against the operations of another year, or that a reasonable allowance for a given year on account of depletion contemplates something other than the exhaustion which occurred in such year. In fact to grant what the petitioner is asking would be giving to it in the taxable year that which the parties are agreed the statute expressly prohibited it from taking in such earlier years and when we find nothing in the statute to permit such a deduction.

In view of the foregoing, we are of the opinion that in determining the depletion allowance for 1918 the commissioner was correct in taking into consideration the actual depletion sustained from March 1, 1913, to December 31, 1915, regardless of the depletion which was allowable as a deduction for income tax purposes in those years.

The original petition also contained an assignment of error with respect to the rate applied by the commissioner in his determination of petitioner's profits tax under the provisions of section 328 of the revenue act of 1918, but no evidence was introduced on account thereof nor was this error included in the amended petition or urged in the brief filed by the petitioner.

21

Reviewed by the board.

Judgment will be entered for the respondent.

Trussell, Green, and Van Fossan dissent.

*Dissenting opinion*

TRAMMELL, dissenting: The deduction allowed for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. (Lynch v. Alworth-Stephens Co., 267 U. S. 364.) The end sought in an exhaustion allowance is to have the capital sum invested in a wasting asset returned to the taxpayer as a charge against receipts annually realized from the asset and in this way avoid taxing a return of capital.

The entire amount of such receipts is not taxable, but only so much thereof as does not represent a return of capital. (Edith Andrews Logan, 12 B. T. A. 686.) In essence, the deduction for depletion does not differ from the deduction for depreciation, and the proviso limiting the amount of such deductions to the amount of the capital invested shows that such deductions are to be regarded as a return of capital. (United States v. Ludey, 274 U. S. 295.)

In the case of oil wells operated by a lessee, the value of the lease contract is at all times in proportion to the recoverable oil content. As the oil is pumped out the value of the lease is correspondingly diminished, so that when the oil reserve is fully exhausted the value of the lease is likewise exhausted, and no part of the capital asset remains. The process is comparable to the gradual sale of the lease in units measured by the barrels of oil recovered and sold. The proceeds from the sale of the oil represent in part a return of capital and in part taxable income.

In United States v. Ludey, supra, the court in the course of its opinion said:

"The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, off the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the
22 plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to procide [provide] an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction for the loss of the same capital assets.

* * * * * * *

"The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed."

In the Ludey case the court had before it the question of whether a gain was realized or a loss sustained upon the sale in 1917 of oil-mining properties, and the solution of the question depended primarily on whether deductions for depletion and depreciation were to be made from the original cost. The property consisted, besides mining equipment, in part of oil land held in fee and in part of oil-mining leases, which had been owned and operated by Ludey for several years. The tax in controversy was computed on the basis of cost reduced by the full amount of depreciation and depletion sustained, whether or not allowable by law as a deduction from gross income in past years, and the Government contended that this was the correct basis for the computation. On the other hand, Ludey contended that the correct basis for determining gain or loss on the sale of his property was original cost reduced by an amount not in excess of the deductions actually claimed by and allowed to him during the years from 1913 to 1916 on account of depletion and depreciation, without regard to the amount he was entitled to deduct under the law. The court declined to accept either contention, saying:

23 "Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years."

In accordance with the foregoing rule, if the petitioner in this proceeding had sold its oil-mining lease in 1918, the basis for determining gain or loss on such sale would have been the March 1, 1913, value, less the aggregate amount which it was entitled to deduct in the preceding years on account of depletion, without regard to either the amount of the depletion actually sustained or the amount of the deductions actually claimed and allowed.

This being the sound rule for determining gain or loss on the sale of the whole property, I am unable to perceive any fundamental distinction in the case of a gradual sale of the property through depletion.

I am further impelled to this view by the fact that the application of this rule will provide an equitable method by which the entire amount of the petitioner's capital investment may be returned to it through depletion allowances, tax free, which, as pointed out above, is the manifest purpose of the statutory provisions for all exhaustion allowances. This, in my opinion, will provide, as required by the statute, a reasonable allowance for depletion according to the peculiar conditions in this case.

The aggregate amount which the petitioner herein was entitled to deduct from gross income for the years 1913, 1914, and 1915 as depletion allowances was $6,322.02. It is my opinion therefore that the correct depletion unit to be used in computing the petitioner's depletion allowance for 1918 should be determined by reducing the agreed March 1, 1913, value (which, under the statute, must be taken in this case in lieu of original cost) by the amount of $6,322.02,

the amount of depletion which the petitioner was entitled to deduct, instead of the amount of $91,686.15.

Lansdon and Siefkin agree with this dissent.

Now, November 6, 1929, the foregoing findings of fact and opinion certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

24 Before United States Board of Tax Appeals

*Decision*

Pursuant to the board's findings of fact and opinion, promulgated March 20, 1929, it is ordered and decided that there is a deficiency of $29,838.44 for the year 1918.

Entered Mar. 21, 1929.

(Signed) B. H. LITTLETON,
*Member, United States Board of Tax Appeals.*

Now, November 6, 1929, the foregoing decision certified from the record as a true copy.

B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

Before United States Board of Tax Appeals

*Notice of petition for review*

Filed September 5, 1929

*To the Commissioner of Internal Revenue, Washington, D. C.*

SIR: Please take notice that the annexed is a copy of a petition filed September 5, 1929, with the United States Board of Tax Appeals for a review of its decision in the above-entitled cause by the Circuit Court of Appeals for the Tenth Circuit.

PHIL D. MONDLOCK,
*Counsel for Petitioner,*
*815 Fifteenth Street N. W., Washington, D. C.*

Receipt is acknowledged of a copy of the petition for review set forth above with notice that it was filed September 5, 1929.

R. H. LUCAS,
*Commissioner of Internal Revenue,*
By C. M. CHAREST,
*General Counsel, Bureau of Internal Revenue.*

## Before United States Board of Tax Appeals

*Petition for review*

Filed Sept. 5, 1929

*To the Circuit Court of Appeals for the Tenth Circuit:*

Your petitioner, the Thompson Oil & Gas Co., respectfully shows:

25 First. This is a proceeding for review by the United States Circuit Court of Appeals for the Tenth Circuit of a decision of the United States Board of Tax Appeals, entered on March 20, 1929, and redetermining a deficiency in income and profits tax for the year 1918 against the petitioner in the sum of $29,838.44.

Second. Your petitioner is an Oklahoma corporation, with offices at Tulsa, Oklahoma. It filed its Federal income and profits tax return for 1918 with the collector of internal revenue at Oklahoma City.

Third. The nature of the controversy before the Board of Tax Appeals was the determination of income and profits taxes under the revenue act of 1918, involving a determination of the proper deduction from gross income for depletion of oil properties for the year 1918. The determination of such deduction involved the questions:

1. Whether the petitioner was entitled, through the allowance of depletion as a deduction from income, eventually to recover the full amount of the March 1, 1913, value of its oil property less the depletion which was actually allowed as a deduction from income for the years 1913 to 1915, inclusive, based on 5% of production, as provided by the revenue act of 1913.

2. Whether the respondent, in determining the base upon which the depletion allowance for 1918 should be computed, was correct in reducing the March 1, 1913, value of petitioner's oil property, fixed at $156,645.00 by depletion, sustained in the period 1913–1915, amounted to $91,686.15, or whether respondent should have reduced the agreed value of the oil property, amounting to $156,645.00, only by the depletion allowed as a deduction under the revenue act of 1913, which amounted to $6,322.02.

3. The errors committed by the Board of Tax Appeals upon which the petitioner relies as the basis of this proceeding are as follows:

(1) The board erred in determining that, for the purpose of fixing the base upon which the petitioner's depletion allowance for 1918 should be computed, the March 1, 1913, value of petitioner's property, stipulated as $156,645.00, should be reduced by depletion sustained for the period 1913 to 1915, inclusive, amounting to $91,686.15.

(2) The board erred in not finding that the March 1, 1913, value of petitioner's property, amounting to $156,645.00, should be re-
26 duced only by the amount of depletion allowed as a deduction under the revenue act of 1913 for the years 1913 to 1915, inclusive, stipulated as $6,322.02.

Wherefore your petitioner prays that this court may review the action of the Board of Tax Appeals in this cause, reverse the decision of the board, and remand the proceeding for a redetermination based upon the allowance of a deduction for depletion of oil properties computed by reference to a recoverable balance of $150,322.98 at December 31, 1915, and such other factors as may be proper in the premises.

PHIL D. MORELOCK,
*Attorney for Petitioner,*
*710 Land Bank Building, Kansas City, Missouri.*

[*Duly sworn to by Phil D. Morelock; jurat omitted in printing.*]

Now, November 6, 1929, the foregoing petition for review, notice of filing and proof of service certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

Before United States Board of Tax Appeals

*Præcipe for record on review*

Filed Nov. 1, 1929

*To the Clerk of the Board of Tax Appeals:*

SIR: You will please incorporate in the transcript to be certified to the Circuit Court of Appeals for the Tenth Circuit in this proceeding the following portions of the record:

27–28 1. The docket entries of proceedings before the board.
2. The pleading before the board.
3. The findings of fact, decision, and opinion of the board.
4. The petition for review.

PHIL D. MORELOCK,
*Attorney for Petitioner.*
C. M. CHAREST,
*General Counsel, Bureau of Internal Revenue,*
*For Respondent.*

Now, November 6, 1929, the foregoing præcipe certified from the record as a true copy.

B. D. GAMBLE,
*Clerk, U. S. Board of Tax Appeals.*

[File endorsement omitted.]

29 Before United States Board of Tax Appeals

THOMPSON OIL & GAS COMPANY, PETITIONER
vs.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
Docket No. 10600

*Stipulation enlarging time*

Filed in U. S. C. C. A. Nov. 16, 1929

It is stipulated that the time within the clerk of the Board of Tax Appeals may certify the record herein to the Circuit Court of Appeals for the Tenth Circuit be enlarged to November 19th, 1929.

PHIL D. MORELOCK,
*Attorney for Petitioner.*
C. M. CHAREST,
*General Counsel for Respondent.*

[File endorsement omitted.]

30–31 [Appearances of counsel omitted in printing.]

32 In United States Circuit Court of Appeals for the Tenth Circuit

THOMPSON OIL & GAS COMPANY, PETITIONER
vs.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
No. 192

*Stipulation enlarging time*

Filed Feb. 19, 1930

It is hereby stipulated and agreed by and between the attorneys for the petitioner and respondent in the above-entitled cause that the time for filing the printed brief on behalf of the respondent be extended to include February 17, 1930, a copy of the manuscript of the brief having been served upon counsel for the petitioner on
33 February 10, 1930, the date on which it was due.

J. S. Y. IVINS,
*Attorney for Petitioner.*
C. M. CHAREST,
*Attorney for Respondent.*

[File endorsement omitted.]

In United States Circuit Court of Appeals

[Titles omitted.]

*Minute entries*

Feb. 20, 1930

This cause comes on to be heard, J. S. Y. Ivins, esquire, appearing as counsel for petitioner.

Thereupon, upon his motion, it is now here ordered by the court that appellant may file twenty copies of a reply brief herein instanter, which is accordingly done.

34 Feb. 21, 1930

This cause comes on to be heard and is argued by counsel, Phil D. Morelock, esquire, and J. S. Y. Ivins, esquire, appearing for petitioner, J. L. Monarch, esquire, appearing for respondent.

Thereupon this cause is submitted to the court.

35 In United States Circuit Court of Appeals, Tenth Circuit

No. 192. February term, 1930

THOMPSON OIL & GAS COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On petition to review the decision of the United States Board of Tax Appeals

Mr. Phil D. Morelock, Mr. J. S. Y. Ivins (Shouse, Doolittle, Morelock & Shrader and Holmes, Brewster & Ivins were with them on the brief), for petitioner.

Mr. J. Louis Monarch, special asst. to the Atty. Genl. (Mr. G. A. Youngquist, Asst. Atty. Genl. Mr. Sewall Key, special asst. to the Atty Genl.; Mr. C. M. Charest, Gen. Counsel, Bureau of Internal Revenue; and Mr. John MacC. Hudson, special atty., Bureau of Internal Revenue, were with him on the brief), for respondent.

Before LEWIS, COTTERAL, and PHILLIPS, Circuit Judges

PHILLIPS, Circuit Judge, delivered the opinion of the court.

*Opinion*

April 4, 1930

36 This is a proceeding to review a decision of the Board of Tax Appeals. The petitioner was the owner of an oil and gas lease acquired prior to March 1, 1918. On that date its recoverable oil reserves were 278,000 barrels and the value thereof was $156,645. On January 15, 1916, petitioner acquired an extension of

its lease for a consideration of $30,000, which increased its recoverable oil reserves by 300,000 barrels.

The controversy concerns the proper depletion allowance for the year 1918.

The commissioner determines the amount of sustained depletion for a given year as follows: He divides the value of the oil reserves at the beginning of the year, based on their March 1, 1913, value (or their cost, if acquired thereafter) by the number of barrels of oil reserves at the beginning of such year, to obtain in the form of a decimal the rate per barrel of depletion. Such decimal is the amount of capital investment in each barrel of such oil reserves. He multiplies the number of barrels produced in such year by such decimal and thereby arrives at the amount of sustained depletion for that year.

The per barrel depletion unit of petitioner for 1913 was $0.56347. Theoretically the rate per barrel of depletion is determined each year after deducting the depletion for the preceding year from the capital investment and the production for the preceding year from the oil reserves, but unless a part of the oil reserves is sold or new oil reserves are acquired the rate per barrel remains constant.

Employing the above method, the commissioner determined the aggregate of petitioner's sustained depletion for 1913, 1914, and 1915 to be $91,686.15.

The revenue act of 1913 limited the depletion allowance to 5% of the gross income, and under this act the petitioner was entitled to deduct a depletion allowance of $6,322.02 for the years 1913 to 1915, inclusive.

37 Because of the acquisition in 1916 of additional oil reserves a redetermination of the rate per barrel of depletion was necessary. To the value of the oil reserves on March 1, 1913, less the sustained depletion for 1913, 1914, and 1915, the commissioner added the cost of the 1916 acquisition. To the oil reserves on March 1, 1913, less the production for 1913, 1914, and 1915, the commissioner added the additional reserves acquired in 1916. He divided the former result by the latter to obtain the rate per barrel of depletion for 1916. The new per barrel depletion unit was $0.22866. Since there was no change in the oil reserves by purchase or sale after 1916, the decimal remained constant and was applied in determining the depletion sustained for the years 1916 and 1917 and the depletion allowable for the year 1918.

The sustained depletion for 1916 was $11,307.69 and for 1917 was $8,964.39.

Sec. 12 (a) second, of the revenue act of 1916, limited the depletion allowance, in case of an oil and gas well, to "a reasonable allowance for actual reduction in flow and production" instead of the depletion actually sustained.

Paragraph 537 of Regulations 33, revised, provided that when the sum of the credits for depletion should equal the value or cost of

the property no further deduction for depletion would be allowed with respect to such property.

In arriving at the capital investment on January 1, 1918, the commissioner deducted not the allowable but the sustained depletion, which aggregated the sum of $111,958.23.

Counsel for the petitioner contend that the capital investment on January 1, 1918, should have been determined by adding the cost of the 1916 acquisition to the 1913 value of the oil reserves and deducting the allowable, as distinguished from the sustained, depletion for the years 1913 to 1917, inclusive, and that the rate per barrel of depletion for the year 1918 should have been determined by dividing such result by the number of barrels of oil reserves remaining on January 1, 1918, after adding the 1916 acquisition and deducting the production from 1913 to 1917, inclusive; in other words, that allowable instead of sustained depletion should have
38 been used in determining the capital investment in oil reserves on January 1, 1918.

Counsel for the commissioner contend that the capital investment, upon which the depletion allowances provided for by the revenue act of 1918 should be applied, is the value of the oil reserves on March 1, 1913, plus the cost of the 1916 acquisition, less the sustained, as distinguished from the allowable, depletion during the period from 1913 to 1917, inclusive.

The majority opinion of the Board of Tax Appeals upheld the contentions of the commissioner. There was a dissent in which three of the members joined and three other members dissented without opinion.

Sec. 234 of the revenue act of 1918 in part provides:

"(a) That in computing the net income of a corporation subject to the tax imposed by sec. 280 there shall be allowed as deductions: * * *

"(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deduced: Provided, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: Provided further, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the commissioner with the approval

39 of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

Art. 201 of Regulations 45, under the revenue act of 1918, in part provides:

"Sections 214 (a) (10) and 234 (a) (9) provides that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. * * *

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital investment in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions.

"When used in these articles of the regulations covering depletion and depreciation—

"(a) The term 'basis date' indicates the date of valuation, i. e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913, or the date of discovery, or within 30 days thereafter, in the case of discovery."

Art. 203 of Regulations 45, under the revenue act of 1918, in part provides:

"(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not from the basic date to the taxable year. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation."

40 Counsel for the petitioner rely upon United States v. Ludey (274 U. S. 295). That case involved the amount of income, under the revenue act of 1916 as amended by the revenue act of 1917, derived from the sale in 1917 of mining properties, including oil reserves, acquired in part prior to March 1, 1913.

Until 1924 none of the revenue acts expressly provided that in computing gain from the sale of property deduction should be made from the original cost on account of depreciation and depletion.

Ludey contended, first, that no deduction should be made from cost on account of depreciation and depletion, and second, if any such reduction were made, it should be the amount claimed by him rather than the greater amount which he might have claimed in his income tax returns.

On the other hand, the Government contended that in the extraction and sale of oil Ludey consumed so much of the equipment as was represented by depreciation and disposed of so much of the

oil reserves as was represented by depletion, and for that reason the amounts of the sustained or actual depreciation and depletion should be deducted from the cost of the property in computing the income resulting from the sale.

The court held that "the theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it" and that "the depreciation charged is the measure of the cost of the part which has been sold"; that "when the plant is disposed of after years of use the thing then sold is not the whole thing originally acquired"; that "the amount of depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties"; that "any other construction would permit a double deduction for the loss of the same capital assets"; and that "the amount of allowance for depreciation is the sum which should be set aside for the taxable year in order that at the end of the useful life of the plant in
41 the business the aggregate of the sum set aside will (with the salvage value) suffice to provide an amount equal to the original cost."

The court further held that the depletion charge, permitted as a deduction from the gross income in determining taxable income of mines for any one year, "represents the reduction in the mineral contents of the reserves from which the product is taken"; that "in essence the deduction for depletion does not differ from the deduction for depreciation"; and that the deduction for depletion "is to be regarded as a return of capital."

The court concluded that the deduction to be made from the original cost on account of depreciation and depletion "should be the aggregate amount which the taxpayer was entitled to deduct in the several years."

Counsel for the petitioner assert that it follows, from the decision in the Ludey case, (1) that depletion and depreciation are the same; (2) that depletion is a gradual sale of the oil reserves; (3) that in determining capital investment as of January 1, 1918, allowable depletion, instead of sustained depletion, should be deducted for the years 1913 to 1917, inclusive.

Counsel for the petitioner further assert that the history of the revenue acts and their several provisions relative to depletion indicate that Congress intended the taxpayer should ultimately receive as depletion allowances the value of his capital investment on January 1, 1913, plus allowable capital additions; that such is the construction of the 1918 act made by art. 201 of Regulations 45; that such capital investment will be returned in the instant case only by the application of the construction for which petitioner contends.

On the other hand, counsel for the commissioner assert that the tax on the product of a mine or oil well is an excise tax and that Congress might legally exact such tax without making any allow-

ance for depletion and cite Stanton v. Baltic Mining Co. (240 U. S. 103) in support of such contention. From such premise
42 they argue that Congress elected in the 1913 act, to limit the depletion allowance to 5% of the gross income, and in the 1916 act to limit the depletion allowance to a reasonable allowance for actual reduction in flow and production, and that by the 1918 act Congress intended to make provision for depletion actually sustained in 1918 and in the years subsequent thereto, and Congress did not intend to provide for allowance in 1918 and the years subsequent thereto for depletion actually sustained but not allowed prior to 1918.

While the Ludey case involved deduction of depletion from cost upon the immediate sale of the entire oil reserves and the instant case involves the depletion allowance upon a gradual sale of a part of the oil reserves, the analogy between them is close, and it is our opinion that the principles laid down in the Ludey case control the instant case.

It is not strictly a question of allowing in 1918 a part of the depletion sustained in the preceding years, but rather one of determining the cost of the reserves remaining on January 1, 1918, for the purpose of computing depletion allowances for that year under the revenue act of 1918. If such depletion results from a gradual sale of the property, and we think it does, then the cost of the oil sold in 1918 should be computed on the basis laid down in the Ludey case. Depletion represents the cost of the oil sold in 1918. Such cost would be the value of the oil reserves on March 1, 1913, plus the cost of the 1916 acquisition, less the allowable depletion for the years 1913 to 1917, inclusive, divided by the number of barrels of oil reserves remaining January 1, 1918, and multiplied by the number of barrels of oil produced in 1918, and would be the depletion allowance for the year 1918. It is true that the result obtained does not reflect the actual cost, because there was a greater sustained depletion; but neither did the application of the rule laid down in the Ludey case reflect the actual cost of the property sold, because there was a greater sustained depletion.

There can be no doubt that once the capital investment or cost of the oil reserves remaining on January 1, 1918, is determined the 1918 act intended a depletion allowance that would return that capital investment by the expiration of the lease term.

The decision of the Board of Tax Appeals is reversed and the proceeding remanded with instructions to redetermine the taxes in accordance with this opinion.

43 In United States Circuit Court of Appeals

192

THOMPSON OIL & GAS COMPANY, PETITIONER
vs.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for review from the United States Board of Tax Appeals—District of Oklahoma

*Judgment*

April 5, 1930

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals for a review of the decision of said board and was argued by counsel.

On consideration whereof it is now here ordered and adjudged by this court that the decision of the said United States Board of Tax Appeals in this cause be, and the same is hereby, reversed, and that this cause be, and the same is hereby, remanded to said United States Board of Tax Appeals with instructions to redetermine the taxes in accordance with the opinion of this court.

44 In United States Circuit Court of Appeals

[Title omitted.]

*Motion for order staying mandate*

Filed May 8, 1930

Now comes the Commissioner of Internal Revenue, the respondent herein, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, and moves the court to enter an order herein staying its mandate for a period of three months from the date of the entry of the judgment herein.

In support of this motion the said Commissioner of Internal Revenue respectfully shows to the court that he is considering the advisability of filing in the Supreme Court within the three months' period provided by statute in that respect a petition for certiorari in this cause; that it is highly probably that such petition for certiorari will be filed; and that he believes it undesirable under such circumstances to have the mandate of this court issue in accordance with the general rules of this court.

C. M. CHAREST,
*General Counsel, Bureau of Internal Revenue.*

[File endorsement omitted.]

45 In United States Circuit Court of Appeals

[Title omitted.]

*Order denying motion for stay of mandate*

May 14, 1930

This cause came on to be heard on the motion of respondent for a stay of the mandate herein and was submitted to the court.

On consideration whereof it is now here ordered by the court that said motion be, and the same is hereby, denied.

In United States Circuit Court of Appeals

*Mandate*

UNITED STATES OF AMERICA, *ss:*

*The President of the United States of America to the honorable the Members of the United States Board of Tax Appeals, Greeting:*

Whereas, lately before you, or some of you, in a cause between Thompson Oil and Gas Company, petitioner, and Commissioner of Internal Revenue, respondent, Docket No. 10600, the decision of the said United States Board of Tax Appeals, entered on March 21, 1929, was in the following words, viz:

46 "Ordered and decided that there is a deficiency of $29,838.44 for the year 1918."

as by the inspection of the transcript of the record of the said United States Board of Tax Appeals which was brought into the United States Circuit Court of Appeals, Tenth Circuit, by virtue of an appeal agreeably to the act of Congress in such case made and provided, fully and at large appears.

And whereas at the February term, in the year of our Lord one thousand nine hundred and thirty, the said cause came on to be heard before the said United States Circuit Court of Appeals on the transcript of the record from the United States Board of Tax Appeals and was argued by counsel.

On consideration whereof it is now here ordered and adjudged by this court that the decision of the said United States Board of Tax Appeals, in this cause be, and the same is hereby, reversed, and that this cause be, and the same is hereby, remanded to said United States Board of Tax Appeals with instructions to redetermine the taxes in accordance with the opinion of this court.

APRIL 5, 1930.

You therefore are hereby commanded that such further proceedings be had in said cause not inconsistent with the opinion and judg-

ment of this court as according to right and justice, and the laws of the United States, ought to be had, the said appeal notwithstanding.

47 Witness the Honorable Charles E. Hughes, Chief Justice of the United States, the 17th day of May, in the year of our Lord one thousand nine hundred and thirty.

ALBERT TREGO,
*Clerk of the United States Circuit Court of Appeals, Tenth Circuit.*

48 [Clerk's certificate to foregoing transcript omitted in printing.]

49 Supreme Court of the United States

*Order allowing certiorari*

Filed October 13, 1930

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Tenth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[Endorsement on cover:] Filed No. 35210. U. S. Circuit Court of Appeals, Tenth Circuit. Term No. 288. Robert H. Lucas, Commissioner of Internal Revenue, petitioner, vs. Thompson Oil & Gas Company. Petition for a writ of certiorari and exhibit thereto. Filed July 11, 1930. File No. 35210.

# SUPREME COURT OF THE UNITED STATES

## OCTOBER TERM, 1930

---

No. ——

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER, v. THOMPSON OIL & GAS COMPANY

---

*Order extending time within which to apply for writ of certiorari*

On consideration of the motion of the Solicitor General in the above-entitled cause, and good cause therefor having been shown,

*It is now here ordered*, That the time within which petition for writ of certiorari may be filed herein be, and the same is hereby, extended for a period of ten days from this date.

WILLIS VAN DEVANTER,
*Associate Justice of the Supreme Court of the United States.*

Dated this 3d day of July, 1930.

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JUL 11 1930
CHARLES ELMORE CROPLEY
CLERK

No. 288

# In the Supreme Court of the United States

OCTOBER TERM, 1930

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

THOMPSON OIL & GAS COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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# In the Supreme Court of the United States

OCTOBER TERM, 1930

No. ——

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, petitioner

*v.*

THOMPSON OIL & GAS COMPANY

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

### PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Tenth Circuit, entered in the above cause on April 5, 1930 (R. 39), reversing the decision of the United States Board of Tax Appeals. (R. 16.)

### STATEMENT

The question presented is whether in determining the value or cost of oil reserves to be used in calculating the unit value per barrel upon which

depletion is annually computed under Section 234 (a) (9) of the Revenue Act of 1918 with respect to an oil lease acquired prior to March 1, 1913, the Commissioner is required to deduct from the value of the lease on March 1, 1913, plus the cost of capital additions thereafter, (1) the actual depletion sustained since March 1, 1913, or (2) merely the depletion allowed as deductions from gross income since that date.

The respondent owned an oil and gas mining lease acquired prior to March 1, 1913. On that date the recoverable oil reserves embraced by the lease were 278,000 barrels, and the value thereof was $156,645, or $.56347 per barrel. In the last ten months of 1913, in 1914 and 1915, the respondent extracted 162,717.03 barrels of oil, and, at the unit rate mentioned, *sustained* depletion of its oil in the amount of $91,686.15. During this same period the total depletion *allowed* respondent from its gross income amounted to only $6,322.02, because the Revenue Act of 1913, then in force, restricted the annual deduction allowed for depletion to 5% of the gross production of the respondent, which for this period totaled $126,440.44. (R. 14–15; see *infra*, p. 7.)

In 1916 the respondent secured an extension of its lease at a cost of $30,000, by which its oil reserves were increased 300,000 barrels. At this time there remained of the original reserve 115,283 barrels, having a March 1, 1913 value of $64,958.85. By adding to this depleted March 1, 1913 value the

cost of the extension of the lease, and by increasing the remaining oil reserves by the additional 300,000 barrels the Commissioner found a new total recoverable reserve of 415,283 barrels, having a basic value or cost of $94,958.85, or $.22866 per barrel. (R. 15–16.)

In 1916 and 1917 the respondent produced 49,452 barrels and 39,204 barrels of oil, respectively, on which it sustained depletion in the respective amounts of $11,307.69 and $8,964.39. During 1918 the respondent produced 33,697 barrels, upon which it sustained depletion in the amount of $7,705.16, determined at the unit rate of $.22866 per barrel, which amount the Commissioner allowed as a deduction from gross income for 1918. (R. 16.) It is the depletion allowance for 1918 which is here in question.

Respondent contended that the unit rate of depletion per barrel for 1918 should have been based upon the original March 1, 1913 value of the oil reserves, plus the cost of the extension of the lease, and less only that portion of the depletion sustained in 1913, 1914 and 1915 which was *allowed* to it as deductions (i. e., $6,322.02). The Commissioner, in determining the capital value of the total reserve upon which depletion for 1918 should be based, adopted the March 1, 1913 value of the reserve, plus the cost of the extension of the lease, less the full amount of the depletion *sustained* in the years 1913, 1914 and 1915 (i. e., $91,686.15), holding that

the entire depletion sustained in those years should be deducted from the original March 1, 1913 value whether allowable as deductions or not. Note: No question is here raised as to the correctness of the amount of depletion deducted by the Commissioner for 1916 and 1917 in computing the depletion allowance for 1918.

The Board of Tax Appeals sustained the Commissioner. (R. 20.) The Circuit Court of Appeals, relying upon *United States* v. *Ludey*, 274 U. S. 295, held that in determining in 1918 the value or cost of the reserves then recoverable through depletion allowances there should be deducted from the original March 1, 1913 value or cost only so much of the depletion sustained between March 1, 1913 and December 31, 1917 as was legally allowable as deductions during that period, and, accordingly, reversed the decision of the Board. (R. 32–38.)

## SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred in holding that the capital value in 1918 of oil-mining properties, acquired prior to March 1, 1913, recoverable through depletion allowances, is the March 1, 1913, value of the oil reserves, plus the cost of subsequent additions and minus only the depletion of the reserves in prior years which were allowed as deductions from gross income of such years.

## REASONS FOR GRANTING THE WRIT

1. The effect of the decision below is to overthrow regulations which have been in force for ten

years and which have received legislative approval through the reenactment of Section 234 (a) (9) of the Revenue Act of 1918 in later revenue acts without substantial change. Regulations 62, Article 202, construing Section 234 (a) (9) of the Revenue Act of 1921; Regulations 65, Article 202, construing Section 234 (a) (8) of the Revenue Act of 1924; Regulations 69, Article 202, construing Section 234 (a) (8) of the Revenue Act of 1926.

2. The decision below authorizes a deduction in 1918 for depletion actually sustained in earlier years. This is in conflict with the settled principle that losses are deductible only for the year in which sustained (*DeLoss* v. *Commissioner*, 28 F. (2d) 803 (C. C. A. 2d); *Burns* v. *Commissioner*, 31 F. (2d) 399 (C. C. A. 5th), certiorari denied, 280 U. S. 42A), and defeats the purpose of Section II, B of the Revenue Act of 1913 which limited depletion deductions in the case of mines to 5% of the gross value of the production.

3. The instant case presents a question of statutory construction which is of present importance in administering tax laws, since it is involved in numerous cases now pending in the courts, the Board of Tax Appeals and the Bureau of Internal Revenue.

Wherefore, it is respectfully submitted that the petition should be granted.

THOMAS D. THACHER,
*Solicitor General.*

JULY, 1930.

## BRIEF IN SUPPORT OF PETITION

### OPINIONS BELOW

The findings of fact and opinion of the Board of Tax Appeals (R. 14–21) are reported in 15 B. T. A. 993. The opinion of the Circuit Court of Appeals (R. 32–38) is not yet reported.

### JURISDICTION

The order of the Circuit Court of Appeals reversing the decision of the Board of Tax Appeals was entered on April 5, 1930. (R. 39.) Jurisdiction is conferred upon this Court by Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

### QUESTION PRESENTED

Whether under Section 234(a)(9) of the Revenue Act of 1918 in determining for any taxable year the capital value recoverable through depletion allowances of oil-mining properties acquired prior to March 1, 1913, there should be deducted from the March 1, 1913 value the amount of depletion actually *sustained* in earlier years or only so much of such depletion as was *allowable* as deductions in those years.

The Revenue Act of 1913, c. 16, 38 Stat. 114, 167 provides in part:

SECTION II. B.

* * * * *

That in computing net income * * * there shall be allowed as deductions: * * * sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, * * *.

The Revenue Act of 1916, c. 463, 39 Stat. 756, 767–768, provides in part:

SEC. 12. (a) In the case of a corporation * * * such net income shall be ascertained by deducting from the gross amount of its income * * *

* * * * *

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including * * * (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; * * *.

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, 1078, provides in part:

SEC. 234. (a) That in computing the net income of a corporation subject to the tax

imposed by section 230 there shall be allowed as deductions:

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of costs up to that date: * * * such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

Regulations 45, promulgated January 28, 1921, under the Revenue Act of 1918, provides:

ART. 203. *Capital recoverable through depletion deductions in the case of lessee.*— (a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year. The capital recoverable

through depletion is the total capital remaining less the sum recoverable through depreciation.

STATEMENT

The facts are sufficiently stated in the petition.

ARGUMENT

On March 1, 1913, respondent's oil reserve contained 278,000 barrels of oil, valued at $156,645. During ten months of 1913, and during 1914 and 1915, 162,717 barrels of oil valued, on a March 1, 1913 basis, at $91,686.15, were removed. During this same period the annual deductions allowed respondent from its gross income on account of depletion totaled $6,322.02—said amount being 5% of respondent's gross production during this period, which was the maximum amount of depletion permitted as a deduction under the Revenue Act of 1913. The regulations under which respondent's 1918 allowance was computed (see p. 8, *supra*) provided that the prior depletion "sustained, whether legally allowable or not" should be deducted from the March 1, 1913 value to determine the basis for the annual allowance. Accordingly, in computing the tax for 1918, the Commissioner based the depletion allowance upon the original March 1, 1913 value of the recoverable oil less the depletion actually sustained in 1913, 1914 and 1915 (i. e. $91,686.15), although during these years the depletion allowable as deductions under the 1913 Act amounted only to $6,322.02. It is not contended

that any of the values used by the Commissioner were erroneous and it is not denied that the oil reserve has been actually depleted in the amount by which it was reduced by the Commissioner in computing the 1918 allowance. Respondent's contention is that the original March 1, 1913 value should not have been reduced by the actual amount of depletion sustained prior to 1918, but only by the amount which Congress in prior years permitted to be deducted from gross income. In determining the annual depletion allowances for 1918 and subsequent years, the respondent would thus increase the value of the remaining oil as fixed by the Commissioner by more than $85,000, although it is conceded that the remaining oil has been correctly valued by the Commissioner.

The question is one of statutory construction. Section 234 (a) (9) provides for "a reasonable allowance" for depletion to be made "under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary." The regulations in question were made pursuant to this statutory authority and the depletion allowance made in this case was strictly in accord with the regulations. But it is contended that the 1918 allowance was not a reasonable one because it was not based upon the theory that there must ultimately be returned to the taxpayer in depletion allowances his entire original capital investment free from tax.

In the years 1913 to 1915, inclusive, when $91,686.15 of depletion was actually sustained, the Revenue Act of 1913 limited the annual depletion deduction to "not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made." (See p. 7, *supra*.) The validity of this arbitrary limit was sustained in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103. Since the decision of the court below authorizes an allowance in 1918 for depletion *actually sustained in earlier years*, the necessary effect of that decision is to give to the taxpayer in 1918 a deduction which the statute expressly prohibited him from taking in earlier years. There is nothing in the 1918 Act which provides that all depletion sustained in any prior year which was not allowable as a deduction from gross income in such year should, in effect, be allowed as part of the depletion deductions in later years, so that when the asset is finally exhausted its full value must have been allowed as deductions from gross income. The 1918 Act merely provides for "a reasonable allowance" and it is submitted that this can not be interpreted to mean more than a reasonable allowance based upon the exhaustion which actually occurs during the year for which the tax is determined.

It is now well settled that an owner of oil and mining properties is not entitled *as a matter of right* to make any deduction from gross income on

account of the extraction and sale of the mineral which produces the income. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503; *Goldfield Consol. Mines Co.* v. *Scott*, 247 U. S. 126; *United States* v. *Biwabik Mining Co.*, 247 U. S. 116; *New Creek Co.* v. *Lederer*, 295 Fed. 433, 435, certiorari denied, 265 U. S. 581. The taxpayer is entitled only to what the statute gives. *Kentucky Tobacco Products Co.* v. *Lucas*, 5 F. (2d) 723, 728. In the Corporation Tax Law of 1909, c. 6, 36 Stat. 11, 112, Congress failed to make provision for any deduction on account of depletion of mineral reserves. In later Acts provision was made for depletion deductions, but in none of the Acts since 1913 has Congress evidenced any intention of offsetting the limited allowance provided by the 1913 Act by a commensurate increase in the basic value of the remaining reserve. The effect of the decision below is to increase fictitiously the value of the respondent's remaining reserve by the $85,000 difference between the depletion sustained and that allowed under the 1913 Act. By that decision a value is attributed to the remaining reserve in excess of its conceded value, and a deduction is permitted in 1918 which was not sustained in that year. This is contrary to the accepted principle that losses are deductible only for the year in which sustained. *DeLoss* v. *Commissioner* (C. C. A. 2d), 28 F. (2d) 803; *Burns* v. *Commissioner* (C. C. A. 5th), 31 F. (2d) 399, certiorari denied, 280 U. S. 42A.

The court below recognized that its decision resulted in attributing an excessive value to the remaining reserve, but thought that result was required by the decision in *United States* v. *Ludey, supra.* That case involved the question of gain or loss upon a *sale* of oil properties. As long ago as *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, it was settled that in order to determine whether there has been gain or loss upon the sale of capital assets there must be withdrawn from the gross proceeds an amount sufficient to restore the capital value that existed at the beginning. Only the amount remaining is income. Accordingly it was necessary in the *Ludey case* to compute the depleted cost by deducting from the original cost only the actual amount of depletion which had been allowed theretofore. In determining gain or loss from a sale the taxpayer must get back his cost, and depletion enters into the calculation for the purpose of determining how much of his cost has already been returned to him. For this purpose the sustained depletion is not important. Therefore, this Court, in the *Ludey case,* decided that the original cost must be reduced only to the extent that it had already been recovered in the form of allowed depletion. But it does not follow that the same rule applies in this case, where no question of gain or loss is involved and where the only question is what allowance Congress intended the taxpayer to have as a deduction from gross income.

Section 234 (a) (9) of the 1918 Act does not provide a deduction of the precise amount of the actual depletion. Nor does the section attempt to provide how the annual allowance shall be determined. This depends upon many variable factors which are impossible of exact ascertainment. Accordingly, Congress merely provided for a "reasonable allowance," to be made under rules and regulations prescribed by the Treasury Department. Under this specific statutory authority the Treasury Department promulgated the regulations which have been referred to above. These regulations have been in force for ten years and have received legislative approval through re-enactment of the pertinent provision of the 1918 Act in subsequent revenue acts without substantial change. (See Regulations 62, Article 202, construing Section 234 (a) (9) of the Revenue Act of 1921; Regulations 65, Article 202, construing Section 234 (a) (8) of the Revenue Act of 1924; Regulations 69, Article 202, construing Section 234 (a) (8) of the Revenue Act of 1926.) We submit that they provide a reasonable allowance for depletion and that under the settled rule the regulations should not be disturbed. *Brewster* v. *Gage*, 280 U. S. 327.

## CONCLUSION

The decision below overturns regulations of many years standing and has introduced confusion and uncertainty in the administration of the tax laws. Many cases, involving in the aggregate large

sums of money, are affected by the decision. In view of this and the need for a definite rule for the guidance of the courts and the Treasury Department it is respectfully submitted that the petition should be granted.

THOMAS D. THACHER,
*Solicitor General.*
G. A. YOUNGQUIST,
*Assistant Attorney General.*
SEWALL KEY,
J. LOUIS MONARCH,
*Special Assistants to the Attorney General.*
PAUL D. MILLER,
*Attorney.*

C. M. CHAREST,
*General Counsel,*
*Bureau of Internal Revenue,*
JOHN MACC. HUDSON,
*Special Attorney,*
*Bureau of Internal Revenue,*
*Of Counsel.*

JULY, 1930.

U. S. GOVERNMENT PRINTING OFFICE: 1930

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CHARLES ELMORE

No. 288

# In the Supreme Court of the United States

OCTOBER TERM, 1930

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

THOMPSON OIL & GAS COMPANY

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT*

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# In the Supreme Court of the United States

OCTOBER TERM, 1930

No. 288

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, petitioner

*v.*

THOMPSON OIL & GAS COMPANY

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT*

## BRIEF FOR THE PETITIONER

### OPINIONS BELOW

The findings of fact and the opinion of the Board of Tax Appeals (R. 9–14) are reported in 15 B. T. A. 993. The opinion of the Circuit Court of Appeals for the Tenth Circuit (R. 21–26) is reported in 40 F. (2d) 493.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 5, 1930. (R. 27.) An order extending the time for filing a petition for certiorari

ten days from the date of the order was signed by a Justice of this Court on July 3, 1930. (R. 29.) Petition for a writ of certiorari was filed July 11, 1930, and the writ was granted October 13, 1930. (R. 29.) Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTION PRESENTED

Whether, under Section 234 (a) (9) of the Revenue Act of 1918, in determining for any taxable year the capital value, recoverable through depletion allowances, of oil-mining properties acquired prior to March 1, 1913, there should be deducted from the March 1, 1913 value of the properties the amount of depletion actually *sustained* in earlier years or only so much of such depletion as was *allowable* as deductions in those years.

## STATUTE AND REGULATIONS INVOLVED

These are set forth in the Appendix, pp 25–27, *infra*.

## STATEMENT

The pertinent facts found by the Board of Tax Appeals are as follows:

The respondent owned an oil and gas mining lease which had been acquired prior to March 1, 1913. (R. 9.) On that date the recoverable oil in the reserve embraced by the lease was 278,000 barrels, and the value thereof was $156,645, or $0.56347 per barrel. (R. 9–10.)

From March 1, 1913, to December 31, 1915, the respondent extracted 162,717 barrels of oil, and at the unit rate mentioned *sustained* depletion in the amount of $91,686.15. (R. 10.) During this same period the total depletion *allowed* the respondent as deductions from gross income, under the Revenue Act of 1913, then in force, was $6,322.02.[1] (R. 11.)

In 1916 the respondent secured an extension of its lease at a cost of $30,000, as a result of which its oil reserve was increased 300,000 barrels. (R. 10.) At this time there remained of the original reserve 115,283 barrels, having a March 1, 1913, value of $64,958.85. By adding to this depleted March 1, 1913, value the cost of the extension of the lease, and by increasing the remaining oil reserves by the additional 300,000 barrels, the Commissioner found a new total recoverable reserve of 415,283 barrels, having a basic value or cost of $94,958.85, or $0.22866 per barrel. (R. 10.) There were no subsequent additions to the reserves.

In 1916 and 1917 the respondent produced 49,452 and 39,204 barrels of oil, respectively, on which it sustained depletion in the respective amounts of $11,307.69 and $8,964.39. During 1918 respondent produced 33,697 barrels of oil, upon which it sustained depletion in the amount of $7,705.16, deter-

[1] Under the Revenue Act of 1913 (p. 25, *infra*) the annual deduction allowed for depletion was restricted to 5% of the gross production of the respondent, which for the period in question totaled $126,440.44. (R. 10.)

mined at the unit rate of $0.2286 per barrel, which amount the Commissioner allowed as a deduction from gross income for 1918. (R. 10.) It is the depletion allowance for 1918 which is here in question. (R. 11.)

The respondent contended that the unit rate of depletion per barrel for 1918 should have been based upon the original March 1, 1913, value of the oil reserves plus the cost of the extension of the lease, and less only that portion of the depletion sustained in 1913, 1914, and 1915,[2] which was *allowed* to it as deductions (i. e., $6,322.02). The Commissioner, in determining the capital value of the total reserve upon which depletion for 1918 should be based, adopted the March 1, 1913, value of the reserve, plus the cost of the extension of the lease, less the full amount of the depletion *sustained* in the years 1913, 1914, and 1915 (i. e., $91,686.15), holding that the entire depletion sustained in these years should be deducted from the original March 1, 1913, value whether allowable as deductions or not.

The Board of Tax Appeals sustained the Commissioner. (R. 17.) Upon appeal the Circuit Court of Appeals, relying upon *United States* v. *Ludey*, 274 U. S. 295, held that in determining in

[2] No question is here raised as to the correctness of the amounts of depletion for 1916 and 1917 deducted by the Commissioner from the March 1, 1913, value in computing in 1918 the capital value of the recoverable reserves upon which the depletion allowance for 1918 was based.

1918 the value or cost of the reserves then recoverable through depletion allowances there should be deducted from the original March 1, 1913, value or cost only so much of the depletion sustained between March 1, 1913, and December 31, 1915 (i. e., $91,686.15), as was legally allowable as deductions during that period (i. e., $6,322.02) and, accordingly, reversed the decision of the Board. (R. 21–26.) This Court granted certiorari on October 13, 1930. (R. 29.)

## SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred in holding that the capital value in 1918 of oil-mining properties, acquired prior to March 1, 1913, recoverable through depletion allowances, is the March 1, 1913, value of the oil reserves, plus the cost of subsequent capital additions and minus only the amounts of depletion of the reserves in prior years which were allowed as deductions from gross income of such years.

## SUMMARY OF ARGUMENT

Section 234 (a) (9) of the Revenue Act of 1918 provides that in the case of oil wells there shall be allowed as a deduction "a reasonable allowance for depletion," said allowance to be based upon the cost or March 1, 1913, value of the property, and to be computed "according to the peculiar conditions in each case," and under rules to be prescribed by the Treasury Department. Pursuant to this authority the Treasury Department promul-

gated Article 203 of Regulations 45 (1920 Edition), which provides that in the case of a lessee of oil property the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity plus (2) subsequent capital additions but minus (3) depletion and depreciation theretofore "sustained, whether legally allowable or not," from the basic date to the taxable year in question. The respondent's depletion allowance for 1918 was computed in strict compliance with this regulation. This regulation has been in substance reissued under each successive Revenue Act and has received legislative sanction through the repeated reenactment of the applicable portion of the 1918 Act. Accordingly it has the force and effect of law.

The annual allowance for depletion is not a matter of right but depends upon the legislative intent. The regulations under which the respondent's 1918 depletion deduction was allowed in the instant case was computed upon a theory which would ultimately restore to the respondent its capital assets as they existed when the 1918 Act became effective, and they therefore gave to the respondent the "reasonable allowance" specified in the statute. Congress did not intend in enacting the Revenue Act of 1918 to allow as deductions for depletion in 1918 that which it expressly refrained from granting as deductions under prior Acts.

*United States* v. *Ludey*, 274 U. S. 295, does not control the instant case. The *Ludey case* involved

the question of *gain or loss* upon a *sale* or final disposition of oil properties, whereas the instant case involves merely the annual depletion allowances to be made under the Revenue Act of 1918 *to an operating company*. In order to determine whether there has been a gain or loss upon the sale of capital assets, there must be withdrawn from the gross proceeds an amount sufficient to restore the capital value. Accordingly, it was necessary in the *Ludey case* to compute the depleted cost of the property sold by deducting from the original cost only the amount of depletion which had been allowable theretofore. Where, as in the instant case, the question depends on the capital value in 1918 of the remaining recoverable oil reserves, it is the depletion which has theretofore been actually *sustained*, whether allowable as deductions theretofore or not, which is determinative.

## ARGUMENT

### THE FULL AMOUNT OF DEPLETION SUSTAINED IN PRIOR YEARS MUST BE TAKEN INTO ACCOUNT IN COMPUTING THE RESPONDENT'S ALLOWANCE FOR DEPLETION IN 1918

The Commissioner of Internal Revenue and the Board of Tax Appeals, in determining the capital value (or cost) of the total oil reserves upon which the respondent's depletion allowance for 1918 should be based, adopted the March 1, 1913, value of the reserves, plus the cost of the extension of the lease, minus the amount of the depletion actually *sustained* in the years 1913 to 1917, inclusive,

holding that the entire depletion sustained in those years should be deducted from the original March 1, 1913, value whether allowable as deductions or not.[1] The depletion actually *sustained* in the years 1913, 1914, and 1915, during which period the Revenue Act of 1913 was in force, was $91,686.15. The depletion *allowed* the respondent in 1913, 1914, and 1915 was only $6,322.02, this amount being 5% of the respondent's gross production during this period, which was the maximum amount of depletion permitted as a deduction under the Revenue Act of 1913 (p. 25, *infra*). The respondent contends, as held by the court below, that in computing the capital value (or cost) of the oil reserves upon which the 1918 allowance should be based, the original March 1, 1913, value should not have been reduced by the amount of depletion *sustained* in 1913, 1914, and 1915, but only by the amount *allowed* by Congress as a deduction from gross income in those years (i. e., $6,322.02).

It is now well settled that a lessee of oil and mining properties is not entitled *as a matter of right* to make any annual deduction from gross income, by way of restoration of capital, on account of the extraction and sale of the mineral which produces the income. He is entitled only to the deduction granted by the statute. *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 373; *Von*

[1] See footnote 2, p. 4, *supra*.

*Baumbach* v. *Sargent Land Co.*, 242 U. S. 503; *Goldfield Consol. Mines Co.* v. *Scott*, 247 U. S. 126; *United States* v. *Biwabik Mining Co.*, 247 U. S. U. S. 116; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103; *New Creek Co.* v. *Lederer*, 295 Fed. 433, 435 (C. C. A. 3rd), certiorari denied, 265 U. S. 581. See *Kentucky Tobacco Products Co.* v. *Lucas*, 5 F. (2d) 723, 728 (W. D. Ky.).[4] Accordingly, the question here involved is solely one of statutory construction.

Section 234 (a) (9) of the Revenue Act of 1918, page 26, *infra*, provides:

> SEC. 234. (a) That in computing the net income of a corporation * * * there shall be allowed as deductions:
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> * * * * *
>
> (9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair

[4] Certain of these cases involved the Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 112, but it has been held that the word "income" has the same meaning under the Sixteenth Amendment that it had under the 1909 Act. *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, 519.

> market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of costs up to that date: * * * such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

The statute thus provides: (1) that "a reasonable allowance" for depletion shall be made, based upon the cost or March 1, 1913, value of the property, and (2) that this allowance shall be made "according to the peculiar conditions in each case," and under rules and regulations prescribed by the Commissioner and the Secretary of the Treasury. The statute does not provide as a deduction the precise amount of the depletion. It does not expressly direct that the allowance must be such that it will, ultimately, return to the taxpayer precisely all, or any specified portion of, the capital investment. Nor does it attempt to prescribe how the annual allowance shall be computed; this obviously depends upon many variable factors which are impossible of exact ascertainment. Accordingly, Congress merely provided for a "reasonable allowance" to be made under rules and regulations prescribed by the Treasury Department.

Pursuant to this authority the Treasury Department on December 29, 1920 (T. D. 3107, 4 C. B. 187), promulgated Article 203 of Regulations 45 (1920 Edition), which provides (p. 27, *infra*):

ART. 203. *Capital recoverable through depletion deductions in the case of lessee.*—(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, *whether legally allowable or not*, from the basic date to the taxable year. * * * (Italics ours.)

From the foregoing it will be seen that the respondent's depletion allowance for the taxable year in question was made *in exact compliance with the applicable regulations*. The respondent does not contend that the allowance made by the Commissioner for 1918 falls short of the actual amount of depletion sustained in 1918. It does not contend that the original March 1, 1913, value used was erroneous, and it is not denied that the reserve was actually depleted in 1918 in the amount which was allowed as a deduction in 1918. Its contention is that under the statute the respondent was entitled to a depletion deduction computed on a basis which will ultimately return to it, tax free, the full value of the capital assets *with which it started on March 1, 1913*, and therefore that in computing the 1918 allowance the original March 1, 1913, value should not have been reduced by the true amount of depletion which was sustained in earlier years but

only by that amount which Congress in those years permitted as a deduction. The contention of the respondent thus requires that the regulations promulgated by the Commissioner be set aside as not permitting "a reasonable allowance."

The statute imposed upon the Commissioner the specific duty of promulgating regulations which would afford a reasonable allowance for depletion. Section 203 of Regulations 45 (1920 Edition) was therefore promulgated, not as an interpretation of the law but as a supplement to it, under express legislative authority. The statute was designedly framed in general terms so as to permit the Department charged with its administration to establish its own method of effecting the legislative intention. It is well settled that regulations made by a department of government, addressed to and reasonably adapted to the enforcement of an Act of Congress, the determination of which is confided to such department, have the force and effect of law, if not unreasonable or inconsistent with the statute. *Maryland Casualty Co.* v. *United States,* 251 U. S. 342, 349; *United States* v. *Morehead,* 243 U. S. 607; *United States* v. *Birdsall,* 233 U. S. 223; *Boske* v. *Comingore,* 177 U. S. 459. And the interpretation of administrative officers expressed in such regulations will not be disturbed except for weighty reasons. *Brewster* v. *Gage,* 280 U. S. 327; *United States* v. *Moore,* 95 U. S. 760, 763.

The regulations in question have been in force since 1920. They have been repeated in substance in the regulations issued under each successive Revenue Act. (See Regulations 62, Art. 203, promulgated under the Revenue Act of 1921; Regulations 65, Art. 203, promulgated under the Revenue Act of 1924; Regulations 69, Art. 203, promulgated under the Revenue Act of 1926; Regulations 74, Art. 223, promulgated under the Revenue Act of 1928.) Even more significant is the fact that Congress, in the light of these regulations, has reenacted in each successive Revenue Act, in substantially the same language, the provision of the Revenue Act of 1918 here involved. (See Sec. 234 (a) (9) of the Revenue Act of 1921; Section 234 (a) (8) of the Revenue Act of 1924; Section 234 (a) (8) of the Revenue Act of 1926; Section 23 (l) of the Revenue Act of 1928.)

Numerous decisions of this Court have enunciated the rule that when Congress reenacts a statute which has received departmental construction, it is deemed to have given implied approval to such interpretation, since it is presumed to have legislated with knowledge of the construction adopted by the executive department. In other words, a departmental interpretation under such circumstances becomes a legislative interpretation, with the force and effect of law. *National Lead Co.* v. *United States*, 252 U. S. 140; *United States* v. *Hermanos y Compania*, 209 U. S. 337; *United States* v. *G. Falk & Brother*, 204 U. S. 143.

We submit that the regulations adopted by the Treasury Department are consistent with the legislative intent. They permit a depletion allowance computed on a basis which would ultimately restore to the respondent the full value of its capital assets as they existed when the Revenue Act of 1918 became effective. There is nothing in the 1918 Act which provides that all depletion sustained in any prior year which was not allowable as a deduction from gross income in such year should, in effect, be allowed as part of the depletion deductions in later years, so that when the asset is finally exhausted its full value as of March 1, 1913, must have been allowed as deductions from gross income. The language of the statute contains no suggestion of a desire to remedy an underallowance of depletion for prior years through an excessive allowance in 1918. The 1918 Act merely provides for "a reasonable allowance," and it is submitted that this can not be interpreted to mean more than a reasonable allowance based upon the exhaustion which actually occurs during the year for which the tax is determined.

In the years 1913 to 1915, inclusive, when $91,686.15 of depletion was actually sustained, the Revenue Act of 1913 limited (p. 25, *infra*) the annual depletion deduction to "not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the com-

putation is made."[5] The validity of this arbitrary limit was sustained in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103. Since the decision of the court below authorizes an allowance in 1918 for depletion *actually sustained in earlier years*, the necessary effect of that decision is to give to the taxpayer in 1918 a deduction which the statute expressly prohibited him from taking in earlier years. Moreover, the effect of the decision below is to increase, in 1918, the value of the respondent's remaining reserve by the $85,000 (approximately) difference between the depletion sustained and the depletion allowed under the 1913 Act. Thus a value has been attributed to the remaining reserve in excess of its conceded value and a deduction is permitted in 1918 which was not sustained in that year. This is contrary to the accepted principle that losses are deductible only for the year in which sustained. *DeLoss* v. *Commissioner*, 28 F. (2d) 803 (C. C. A. 2nd), certiorari denied, 279 U. S. 840; *Burns* v. *Commissioner*, 31 F. (2d) 399 (C. C. A. 5th), certiorari denied, 280 U. S. 564. The taxpayer can not choose the year when he will claim a deduction. *Newman* v. *Commissioner*, 41 F. (2d) 743, 744 (C. C. A. 10th), No. 68, October Term, 1930, certiorari denied, October 13, 1930. *A fortiori*, he can not claim a deduction in a later year when Congress specifically withheld the right from him in the year which the depletion occurred.

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[5] No contention is made that this provision does not apply to oil and gas wells. It has always been so understood.

The court below recognized (R. 26) that its decision resulted in attributing an excessive value to the remaining reserves recoverable through depletion but thought that the instant case was controlled by *United States* v. *Ludey*, 274 U. S. 295. We submit that that case is not controlling here. The *Ludey case* involved the question of gain or loss upon a *sale* of oil properties. It was settled in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, that in order to determine whether there has been a gain or loss upon the sale of capital assets there must be withdrawn from the gross proceeds an amount sufficient to restore the capital value that existed at the beginning. Only the amount remaining is income. Accordingly it was necessary in the *Ludey case* to compute the depleted cost by deducting from the original cost only the amount of depletion which had been allowable theretofore. In determining *gain or loss* from a *sale* the taxpayer must get back his cost free of tax, and depletion enters into the calculation for the purpose of determining how much of his cost has already been returned to him. For this purpose the *sustained* depletion is not important. Therefore, this Court, in the *Ludey case*, decided that the original cost must be reduced only to the extent that it had already been recovered in the form of *allowable* depletion. But it does not follow that the same rule applies in this case, where the only question is what annual al-

lowance Congress intended a taxpayer engaged in the *operation* of an oil well to have as a deduction from gross income.

When, as in the *Ludey case*, the question to determine is how much of the capital has already been returned tax-free, the depletion which has been allowed is determinative, and the depletion which has been sustained is unimportant. But when, as in the instant case, the question is how much of the reserve remains, as of the beginning of any year, to be depleted over its remaining life, the depletion which has been allowed or allowable in earlier years is of no consequence. In order to determine what allowance respondent was entitled to in 1918 it was necessary to determine how much of its original reserve remained at the beginning of 1918. It is obvious that on that date the original March 1, 1913, value can only remain to the extent that it has not already *sustained* depletion. Accordingly, the applicable regulations require the original cost to be reduced by the amount of depletion already sustained whether theretofore allowed or not. We submit that they provide a "reasonable allowance." The rule for which the respondent contends would require that the 1918 value of the oil reserve be increased over its actual value by assuming that some of the oil which had been taken out in earlier years still remained in the reserve.

It is true that in the *Ludey case* this Court said (p. 301):

> The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it.

This Court also said in that case (p. 303) "In essence, the deduction for depletion does not differ from the deduction for depreciation." Apparently it was these statements which led the court below to the conclusion that the *Ludey case* governed the instant case. We do not believe, however, that this Court meant in that case to hold literally that the extraction and sale of a barrel of oil from an oil reserve is *pro tanto* a sale of the oil reserve. It has been held that the receipts from an oil and gas lease are not gains from the sale of capital assets but rents or royalties subject to the income tax. *Berg* v. *Commissioner*, 33 F. (2d) 641 (Ct. of App., D. C.), *Hirschi* v. *United States*, 67 C. Cls. 637. And see cases cited at p. 9, *supra*. But even if the operation of oil properties is a piecemeal sale thereof, it does not follow that in determining the annual allowance for depletion the oil producer must of necessity get back his cost tax free when he sells a barrel of oil before any part of the purchase price is taxable. Because money received under a contract is, in a loose sense, a return of expenditures made in performing the contract, it does not become necessary first to restore the cost before any of the money received may be taxed as income. *Burnet* v. *Sanford & Brooks Co.*, No. 31, October Term, 1930, decided January 5,

1931. The arbitrary allowance of 5% of the gross value of the output for the year, which was made on account of depletion in the Income Tax Act of 1913 (p. 25, *infra*), was sustained by this Court in *Stanton* v. *Baltic Mining Co., supra,* against the contention that the allowance was wholly inadequate and caused the tax to be one upon property because of its ownership. The question is solely one of the legislative intent, and we submit it can not be demonstrated that the 1918 Act was intended to grant depletion allowances for depletion occurring during years when such allowances were expressly denied.

If it can be said that the regulations promulgated by the Commissioner produce a harsh result it may be pointed out that where the question is one of statutory construction arguments addressed to the economic wrong involved in the imposition of the tax are beyond judicial cognizance, even where the court may perceive hardship in taxing receipts as income without providing for deductions on account of the exhaustion of the property. *Brushaber* v. *Pac. R. R. Co.*, 240 U. S. 1; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 525.

Moreover, even if we treat the sale of a barrel of oil as a partial sale of the oil reserve, to apply thereto in the instant case the so-called rule of the *Ludey case* would result in increasing the cost or basis of each barrel sold (for the purpose of determining gain or loss) in 1918 over its actual

cost or basis by reason of the fact that too low a cost or basis was taken for the units sold in earlier years. Such a result finds no justification in the statute.

The rule of the *Ludey case* was first written into the statute by Section 202 (b) (2) of the Revenue Act of 1924 (c. 234, 43 Stat. 253, U. S. C., Title 26, Sec. 933). That section provided in the case of the *sale* of property acquired prior to March 1, 1913, that the value on that date should be adjusted by the depletion previously "allowed." This provision has been repeated, in substance, in the later Revenue Acts, where, however, the word "allowable" is used. (See Section 202 (b) (2) of the Revenue Act of 1926, c. 27, 44 Stat. 9; Section 111 (b) (2) of the Revenue Act of 1928, c. 852, 45 Stat. 791.) But this provision only applies to *sales*. The fact that in the later Acts Congress left the section of the statute relating to the annual depletion allowance (Sec. 234 (a) (9)) substantially as it was in the 1918 and 1921 Acts indicates, we think, that Congress was content to have the rule prescribed by the regulations for computing the annual deductions for depletion continue in effect.

The computation made in the instant case by the Commissioner, pursuant to the regulations, reflects the exact situation with respect to respondent's oil reserve, both at the beginning and at the end of 1918. Unless it can be said that Congress intended

to make an allowance for 1918 and subsequent years which would take into account the limited depletion deduction provided for in the 1913 Act, it would seem that an allowance which is based on actualities is reasonable. In considering respondent's contention it must be remembered that we are dealing, not with any express statutory provision, but only with an asserted implication. The statute is unquestionably general enough to support the Commissioner's regulations, and before it can be said that they do not correctly interpret the Congressional purpose it must clearly appear that a "reasonable allowance" for 1918 contemplated a reduction of 1918 income by a belated allowance for depletion actually sustained in earlier years but denied by the statute then in effect.

In the court below the respondent relied upon Section 201 of Regulations 45 (p. 26, *infra*), which provides:

> ART. 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*— * * *.
>
> The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus

subsequent allowable capital additions (see article 222), but not including land values for purposes other than the extraction of minerals.

There is no inconsistency between Article 201 and Article 203 (p. 27, *infra*). The capital value which Article 201 contemplates being returned to the taxpayer by annual depletion and depreciation deductions is, quite clearly we think, the *capital invested in the property remaining when the 1918 Act became effective*. So far as the instant case is concerned, this would seem to be made perfectly clear by Article 203, almost immediately following.

In the court below it was contended that beginning with the 1918 Act Congress has evidenced a purpose ultimately to return through depletion allowances the exact amount of the capital investment. Assuming that this is true, the capital value to be returned is that existing at the beginning of the year 1918. Moreover, the contention that a legislative intent exists ultimately to return the precise original capital investment tax free is negatived by the fact that the later Revenue Acts have provided for an arbitrary annual depletion allowance based upon a specific percentage of the gross income. (See Section 204 (c) (2) of the Revenue Act of 1926, U. S. C., Sup. III, Title 26, Sec. 936; Section 114 (b) (3) of the Revenue Act of 1928, U, S. C., Sup. III, Title 26, Section 2114.) Under

the 1926 and 1928 Acts the annual depletion allowance is permitted even where the depletion deductions in earlier years have in the aggregate equaled the original cost or March 1, 1913, value. (I. T. 2327, VI–1 C. B. 18; I. T. 2350 VI–1, C. B. 20.)

The court below held that the only "reasonable allowance" intended by the statute was one which would return to the taxpayer tax-free the original cost or March 1, 1913, value. The 1918 Act does not specifically so provide and the Revenue Act in force during 1913, 1914, and 1915 specifically limited the allowance. Congress during those years clearly had no intention to make provision for the return of the exact original cost or March 1, 1913, value. We submit that in enacting the Revenue Act of 1918 Congress did not intend to grant as deductions that which it had expressly refused to grant under the 1913 Act. As the 1918 Act was interpreted in the administrative regulations, the cost to be returned by the annual depletion allowances is only the cost remaining when the statute became effective. It can not be demonstrated, we submit, that Article 203 of Regulations 45, under which the Commissioner computed the respondent's depletion allowance for 1918 in the instant case, does not provide the "reasonable allowance" specified in the statute.

## CONCLUSION.

We respectfully submit that the judgment of the Circuit Court of Appeals should be reversed.

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FEBRUARY, 1931.

# APPENDIX

## STATUTES AND REGULATIONS INVOLVED

The Revenue Act of 1913 (c. 16, 38 Stat. 114, 167) provides in part:

> SECTION II. B.
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> * * * * * * *
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> That in computing net income * * * there shall be allowed as deductions: * * * sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, * * *.

The Revenue Act of 1916 (c. 463, 39 Stat. 756, 767–768) provides in part:

> SEC. 12 (a) In the case of a corporation * * * such net income shall be ascertained by deducting from the gross amount of its income * * *.
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> * * * * * * *
>
> Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including * * * (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; * * *.

The Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1077), provides in part:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * * *
>
> (9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of costs up to that date: * * * such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

Regulations 45 (1920 Ed.), promulgated under the Revenue Act of 1918, provides:

> ART. 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*—* * * The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions (see article 222), but not including land values

for purposes other than the extraction of minerals.

* * * * *

ART. 203. *Capital recoverable through depletion deductions in the case of lessee.*—(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

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# In the Supreme Court of the United States.

OCTOBER TERM, 1930

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DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

*v.*

THOMPSON OIL & GAS COMPANY

---

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT*

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## BRIEF FOR RESPONDENT

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# In the Supreme Court of the United States

OCTOBER TERM, 1930

No. 288

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

*v.*

THOMPSON OIL & GAS COMPANY

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT*

## BRIEF FOR RESPONDENT

### OPINIONS BELOW

The findings of fact and the opinion of the Board of Tax Appeals (R. 9–14) are reported in 15 B. T. A. 993. The opinion of the Circuit Court of Appeals for the Tenth Circuit (R. 21–26) is reported in 40 Fed. (2d) 493.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 5, 1930 (R. 27). An order extending the time for filing a petition for certiorari ten days from the date of the order was signed by a Justice of this Court on July 3, 1930 (R. 29). Petition for a

writ of certiorari was filed July 11, 1930, and the writ was granted October 13, 1930 (R. 29). Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTION PRESENTED

Whether, under Section 234 (a) (9) of the Revenue Act of 1918, in determining for any taxable year the capital value, recoverable through depletion allowances, of oil-mining properties acquired prior to March 1, 1913, there should be deducted from the March 1, 1913 value of the properties the amount of what the Treasury Department calls "sustained depletion" for earlier years, or the amount of "depletion" for earlier years that was *allowable*, under the Revenue Acts then in force, as deductions from gross income.

## STATUTES AND REGULATIONS INVOLVED

These are set forth in an Appendix, pp. 43-77, below.

## STATEMENT

This case involves the question of the proper "depletion" allowance, as a deduction from gross income in computing net income for 1918, to be taken by the respondent on account of exhaustion of capital invested in an oil mining lease.

The taxpayer (respondent) owned an oil mining lease which had been acquired prior to March 1, 1913 (R. 9). The value thereof on that date was $156,645.00 (R. 9, 10). In 1916 the taxpayer se-

cured an extension of its lease at a cost of $30,000 (R. 10). From March 1, 1913 to December 31, 1915, the taxpayer extracted 162,717 barrels of oil. Its deduction for "depletion" in computing net income under the Revenue Act of 1913 was computed, not by reference to the number of barrels extracted, or the value of the reserve at March 1, 1913, but by taking five per cent of the gross income from the sale of the oil. The depletion allowance for 1913–1915, computed by this method amounts to $6,322.02 —hereinafter referred to as "allowable depletion".

The Commissioner of Internal Revenue, in computing the taxpayer's income and profits taxes for 1918 prepared a "depletion schedule" wherein he determined as at March 1, 1913 a reserve of 278,000 barrels of oil and found that the extension in 1916 had added 300,000 barrels to the reserve.[1] Dividing the value by the number of barrels, he determined a "depletion unit". Multiplying the number of barrels, extracted between March 1, 1913 and December 31, 1915, by the "depletion unit" he determined what he calls "sustained depletion" for those years in the sum of $91,686.15 (R. 10). For 1916 and 1917 he found a new "depletion unit" computed by reducing the March 1, 1913 reserve by the number of barrels extracted to December 31, 1915 and increasing the balance by 300,000 barrels acquired in 1916; and reducing the March 1, 1913 value by "sustained deple-

[1] R. 10. These figures were not actually determined until after 1918, but were accepted by the taxpayer as accurate, and so stipulated at the trial. *It should not be assumed that they had been determined in 1913–1915.*

tion" for 1913–1915 and increasing it by $30,000, the cost of the new reserve (R. 10). By applying this unit to the number of barrels extracted in 1916 and 1917, he determined "sustained depletion" for those years.

The estimated oil reserve of March 1, 1913, increased for the extension of 1916, and reduced by the number of barrels of oil actually extracted from March 1, 1913 to December 1, 1917, is 36,627 barrels.[1] About this figure there is no dispute, and it represents the taxpayer's oil reserve at January 1, 1918. The capital recoverable at January 1, 1918, divided by this figure, will give the amount that should be allowed as depletion for each barrel extracted in 1918.

The basic question in this case is: What was the recoverable capital investment in the leasehold at January 1, 1918?

The Commissioner says that the recoverable capital investment at January 1, 1918 is the value at March 1, 1913 plus the cost of extension in 1916, minus "sustained depletion" for the period from March 1, 1913 to December 31, 1917.

The taxpayer claims that the recoverable capital investment in the leasehold at January 1, 1918 is what had been invested (the 1913 value plus the cost of the extension in 1916) reduced by "allowable" depletion for prior years—the amount of capital it had been permitted to recover, tax free, under the

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[1] For detail of figures see footnotes on p. 31.

Revenue Acts of 1913 and 1916. No difference has been claimed to exist between "sustained" and "allowable" depletion for 1916 and 1917,[1] so the dispute resolves itself into the question whether, in determining recoverable capital at January 1, 1918, the investment in the leasehold should be reduced by "sustained" depletion for 1913–1915, as contended by the Government, or by "allowable" depletion for those years, as claimed by the taxpayer.

The Board of Tax Appeals (six members dissenting) sustained the Commissioner (R. 11–17). The Circuit Court of Appeals for the Tenth Circuit, on the authority of *United States* v. *Ludey*,[2] reversed the Board (R. 21–26). This Court granted certiorari on October 13, 1930 (R. 29).

## SUMMARY OF THE ARGUMENT

I. The question involved is purely one of statutory construction. The legislative intent of Congress should be sought in events prior to the enactment of the Revenue Act of 1918—the statutes and regulations in the light of which it was passed—and in contemporaneous departmental construction, rather than in subsequent events relied on by the Government.

Under the Corporation Excise Tax Act of 1909, Treasury regulations allowed depletion of oil wells to be deducted as part of "depreciation", the amount of depletion being determined by "reduction in flow" of wells. The regulations indicated the belief that by

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[1] See Government brief, footnote p. 4.

[2] 274 U. S. 295.

this plan the value would be extinguished coincident with the complete exhaustion of the property, and the thought was to permit the entire basic value to be recovered by deductions from gross income.

Under the Revenue Act of 1913, a deduction for depletion was provided but limited in each year to "not to exceed 5 percentum of the gross value at the mine of the output for the year". This limitation was probably regarded as merely a leveling provision to prevent too much variation between deductions from year to year. It was not expected to deprive taxpayers of the right eventually to recover their entire capital investments. This is shown by the language of Regulations 33, providing that no further deduction shall be made after the capital investment has been recovered.

It subsequently developed that the five per cent limitation did work hardship in certain cases, and the limitation was eliminated in the Revenue Act of 1916.

The Revenue Act of 1916 recognized the computation of depletion by reference to "reduction in flow" and specifically provided that when the aggregate allowances should equal the capital originally invested or the value at March 1, 1913, no further allowance should be made. This clearly indicated the expectation that the entire cost or March 1, 1913 value would eventually be recovered by depletion deductions.

The liberality of the 1916 Act, had it remained in force, would have offset the restriction in the 1913 Act. This was recognized by the Treasury Depart-

ment in Treasury Decision 2447 and Regulations 33 Revised. The latter, explaining the deduction for depletion, said:

"The essence of this provision of law is that the owner or operator of this character of properties shall secure through an aggregate of annual depletion deductions, the return of the amount of capital actually invested, or an amount not in excess of the fair market value as of March 1, 1913, of the properties owned prior to that date."

This history constitutes the background of the Revenue Act of 1918.

II. The Revenue Act of 1918, providing for depletion on discovery values as well as on cost or 1913 value, was intended to be more liberal than the Revenue Act of 1916.

III. The Treasury Department, in close touch with the Revenue Act of 1918 while it was in Congress, published, the day after the bill became law, the preliminary edition of Regulations 45. Article 203 therein did not provide that the basic value of a lease should be adjusted for depletion "actually sustained whether legally allowable or not" but for "deductions for depletion which have or should have been taken to date". This contemporaneous departmental construction of the 1918 Act was exactly the construction the taxpayer now urges.

The permanent edition of Regulations 45, published as Treasury Decision 2831,[1] carried phrase-

[1] April 16, 1919.

ology similar to that in the preliminary edition. It was not until December 30, 1920[1] that the regulation took its present form.

IV. A. The deduction from gross income of depletion is in effect the subtraction from sale price of the cost of assets sold piecemeal.[2] Accordingly, it is not surprising to find that the Revenue Act of 1918 made similar provisions for determining the bases for computing gain or loss on sale and for computing depletion.

B. The 1920 edition of Regulations 45 contained parallel interpretations of the parallel sections of the Act.[3] These interpretations required adjustment to the basis in each case for depletion "*sustained*". If one of these interpretations was erroneous, the other must have been.

C. This Court found one of the parallel interpretations to have been erroneous.[2]

D. It follows that the other is equally erroneous. The Government's effort to distinguish *United States* v. *Ludey* on the ground that it involved a sale while we are here concerned with further exhaustion by depletion, fails in the light of the fact that in the *Ludey* case, at the instance of the Government, this Court held that depletion was in effect a series of sales.

V. The Government's position is inequitable. It would reduce the taxpayer's deductions for depletion

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[1] Treasury Decision 3107.
[2] *United States* v. *Ludey*, 274 U. S. 295.
[3] Articles 1561 and 203.

in years of actual operation and force it to take a loss of $85,364.13 after complete exhaustion of its wells—in a year when it would probably have no income against which the deduction for loss could be applied. The inequity of such treatment was conceded in the Government's brief in the *Ludey* case. The practice of the Bureau of Internal Revenue, in cases not involving adjustment for depletion in 1913–1915, is equitable and should be followed in this case. That procedure has been sustained by the Board of Tax Appeals and the courts.

VI. The departmental constructions relied on by the Government are not such as to be entitled to any weight in determining legislative intent. The provisions of Article 203 of Regulations 45 (1920 edition) were repudiated by the Revenue Acts of 1924, 1926 and 1928.

VII. Every argument here advanced on behalf of the Government was presented and necessarily rejected in *United States* v. *Ludey*.

The judgment of the Circuit Court of Appeals should be affirmed.

## ARGUMENT

### I

### The legislative intent of the Revenue Act of 1918 should be sought in the statutes and regulations preceding its enactment, and in contemporaneous departmental construction, rather than in subsequent events

The question involved is purely one of statutory construction—the interpretation of that part of Sec-

tion 234 (a) (9) of the Revenue Act of 1918 which provides that in computing net income of a corporation there shall be allowed as deductions:

"In the case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: * * * ."

In their effort to support the Treasury Department's position in this case, counsel for the Government claim to find evidence of the legislative intent of Congress in the subsequently promulgated provisions of Article 203 of Regulations 45 (1920 edition) and similar provisions of still later regulations, and in the Revenue Acts subsequent to that of 1918.

It is submitted that the legislative intent of Congress in passing a statute that was considered in 1918 and enacted on February 24, 1919, should be sought in events prior to the enactment—the statutes and regulations in the light of which the 1918 law was passed—and to contemporaneous departmental construction, rather than in subsequent events.

Accordingly, we present a brief history of the treatment of depletion allowances in the Revenue Acts and departmental regulations which form the background of the Revenue Act of 1918.

## HISTORY OF THE STATUTES AND REGULATIONS CONCERNING DEPLETION

### (a) Under the Corporation Excise Tax Act of 1909

The Corporation Excise Tax Act of 1909 provided for the deduction, in computing net income, of "a reasonable allowance for depreciation of property, if any",[1] but was silent as to whether this included an allowance for depletion of natural resources or whether any separate allowance for depletion was permissible.

Article 4 of Regulations 31,[2] promulgated under this act on December 3, 1909, provided:

"*Depreciation.*—The deduction for depreciation should be the estimated amount of the loss, accrued during the year to which the return relates, in the value of the property in respect of which such deduction is claimed that arises from exhaustion, wear and tear, or obsolescence out of the uses to which the property is put, and which loss has not been made good by payments for ordinary maintenance and repairs deducted under the heading of expenses of maintenance and operation or in the ascertainment of gross income. This estimate should be formed upon the assumed life of the property, its cost value, and its use. * * * ."

The use of the word "exhaustion" indicates that the Treasury Department contemplated depletion of natural resources as being included under "depreciation".[3]

[1] Section 38, Second [3] (second). Appendix, p. 49.

[2] Appendix, p. 49.

[3] cf. *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364, 369.

Treasury Decision 1606,[1] approved March 29, 1910, elaborated on Regulations 31 and covered specifically a number of points not dealt with therein. It is interesting to note that it contemplated the estimation of "depreciation" in oil and gas wells, as well as in buildings, machinery, etc., by the process of inventorying and valuing them at the beginning and end of the year. Under this process, depletion actually sustained was deducted from gross income unless offset by increment. It should be borne in mind that it was not until January 15, 1917 that this Court decided[2] that the word "depreciation" in the Act of 1909 did not include depletion of natural resources—the Court had specifically refused to pass upon the question in the earlier case of *Stratton's Independence* v. *Howbert*.[3]

It appears that when Treasury Decision 1606 was promulgated, the Department did not regard depreciation and depletion as deductible because representing a return of capital, but because representing loss in value of assets—a theory later abandoned. The method of computing the deduction was not based on original cost and probable life, or proportionate consumption of the asset, but upon the difference between market value at the beginning and at the end of the year.

Treasury Decision 1675,[4] approved February 11,

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[1] 13 Treasury Decisions 39. See Appendix, p. 50.
[2] *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503.
[3] 231 U. S. 399.
[4] 14 Treasury Decisions 16. Appendix, p. 51.

1911, revised Treasury Decision 1606. It covered, in paragraphs 80 ff., depreciation (in which term it included depletion of natural resources) alike in the cases of mining and of oil producing corporations, and provided for a deduction from gross income for exhaustion of natural deposits and depreciation and obsolescence of improvements, on the basis of the original capital investment. A further deduction was allowed for the unearned increment in value of natural deposits, through the process of excluding a proper proportion from gross income. (Pars. 82–84.) The method was by appraisal of the deposit *en bloc* and its reduction to a unit value—per ton, barrel, etc. Here for the first time the idea of basing the deduction upon the cost (adjusted for increment to the effective date of the law) was proposed.

Since the oil companies had never made a practice of calculating the total oil content or "ultimate production" of their deposits, the method prescribed was impracticable if not impossible of application. In consequence, conferences were held between representatives of the leading oil companies and of the Treasury Department, resulting in the promulgation of Treasury Decision 1755[1] on January 22, 1912, amending Treasury Decision 1675. This Treasury Decision made new regulations to "govern the rate of return of capital invested on the basis of the rate of depletion of oil producing properties," recognizing that the depletion deduction was for the purpose of

[1] 15 Treasury Decisions 12. Appendix, p. 55.

accomplishing a *"return of capital"*. The method of computation adopted was that which had been in practice by the leading oil producing companies for many years. It is known as the "reduction in flow" method, the deduction being computed by comparing the number of barrels produced from a given well over similar periods at the beginning and at the end of the year. Under this method, it was not necessary to estimate the total amount of oil expected to be produced from a well, the only factors essential to the computation being (1) the cost of the well, (2) the rate of flow at the beginning of the year, and (3) the rate of flow at the end of the year.[1] The regulation carried a footnote reading:

"It will be apparent that by the plan suggested the value of the producing property appearing in the capital assets of the company will be automatically and wholly extinguished, coincident with the complete exhaustion of the product, with the exception of such salvage as may remain after said exhaustion."

The scheme was to permit the ultimate recovery, free of taxation, of the entire cost of the property, distributed not according to the number of barrels of oil extracted in each year but according to the comparative rates of flow from year to year. The reduction in flow did not necessarily bear any ratio to the amount of oil produced.

In *Stratton's Independence* v. *Howbert*,[2] the taxpayer claimed as a deduction for depreciation the

[1] The method of computation, should the Court be interested, is explained in T. D. 2447, Appendix, p. 62.

[2] 231 U. S. 399.

entire difference between the proportionate cost of iron ore in the ground and its sale price after extraction. This Court held on December 1, 1913, that the entire difference was not deductible, and found the record insufficient as a basis for allowing any lesser deduction, although it recognized in passing "that the revenues derived from the working of mines result to some extent in the exhaustion of capital". It was not until 1917 that this Court held that "depreciation" under the Act of 1909 did not include depletion of minerals.[1]

In the meantime, Congress, in the light of the Treasury regulations which permitted deductions for depletion of oil, computed by the "reduction in flow" method, enacted the Revenue Acts of 1913 and 1916.

**(b) Under the Revenue Act of 1913**

The Revenue Act of 1913 restricted deduction for depreciation to the loss attributable to use, wear and tear of property, but made a separate provision for depletion of mines, including oil wells by the phrase: "all other natural deposits". The depletion deduction was limited[2] to "not to exceed 5 percentum of the gross value at the mine of the output for the year for which the computation is made". It subsequently appeared that this 5 per cent limitation might work very harshly but at the time it was probably regarded as merely a leveling provision to prevent too much

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[1] *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503.

[2] Section 2 G (b) (second), Appendix p. 58.

variation between deductions from year to year. The fact that it was not expected really to deprive taxpayers of the right to recover their entire capital investments by a series of deductions is shown by the provisions in Article 142 of Regulations 33:

"If the rate of 5 per cent per annum shall return to the corporation its capital investment prior to the exhaustion of the deposits, the rate on which the annual deduction for depletion of deposits is based must be lowered in accordance with the estimated number of years it will take to exhaust the estimated reserves.

"In case the reserves shall be in excess of the estimates, no further deduction on account of depletion shall be made where the capital investment has been returned to the corporation."

TheseR egulations 33,[1] which interpreted the Revenue Act of 1913, made no distinction in the treatment of mines and of oil and gas wells. But there was nothing in them inconsistent with the existing practice under Treasury Decision 1755, except where the 5 per cent limitation might impose a maximum limit upon the deduction. Treasury Decision 1755 was continued in force, and producers of oil took their depletion deductions accordingly. On February 21, 1916, this Court decided *Stanton* v. *Baltic Mining Co.*[2] In that case the taxpayer had claimed that the five per cent limitation would prevent it from recovering the entire cost of its property and urged that this rendered the

[1] Appendix, p. 59.
[2] 240 U. S. 103.

Act unconstitutional. This Court upheld the validity of the statute.

The possible injustice of the five percent limitation was thus called to the attention of Congress, which, in the Revenue Act of 1916, abolished that limitation.

(c) Under the Revenue Act of 1916

By the time the Revenue Act of 1916 was under consideration, the question passed on in *Von Baumbach* v. *Sargent Land Company*[1] had been raised in the lower courts, and Congress avoided any ambiguity in the word "depreciation" by eliminating it and providing for "exhaustion"[2] not only by wear and tear but by depletion; providing "in the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow but by settled production or regular flow",[3] with the restriction that when the allowances so authorized should equal the cost or March 1, 1913 value, no further allowance should be made. By this, the statute very obviously adopted the method provided in Treasury Decision 1755 for computing depletion by reference to "reduction in flow", and also clearly expected that the deductions would eventually equal the cost or March 1, 1913 value of the property.

If the Revenue Act of 1916 had continued in force, a taxpayer, by computing depletion according to

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[1] 242 U. S. 503, holding that the word "depreciation" in the Act of 1909 did not include depletion of minerals.

[2] Which was broad enough to cover depletion. cf. *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364, 369.

[3] Sec. 12 (a) (second). See Appendix, p. 61.

"reduction in flow" would ordinarily have been able, before final exhaustion of his oil reserve, to have recovered, tax free, his entire capital investment (or 1913 value), and only by reason of the statutory limitation on aggregate deductions, would be prevented from recovering even more. The liberality of the 1916 Act, had it remained in force, would have offset the restriction in the 1913 law.

Following the passage of the Revenue Act of 1916 came Treasury Decision 2447,[1] emphasizing the necessity of computing depletion under the "reduction in flow" method, but once more recognizing the legislative intent to allow the entire capital investment at 1913 to be recovered, in the following language:

"The provision of the law authorizing the depletion deduction, designed as it is to provide a means whereby the invested capital of an individual or corporation may not be subject to the tax imposed by this title, * * * [2] * * *. By capital invested, as herein used, is meant the fair market value of the properties as of March 1, 1913, if acquired prior to that date, or their actual cost if acquired subsequent to that date, as it relates to the owner in fee of the properties."

In Regulations 33 Revised,[3] the Treasury Department began to try to get away from the "reduction in flow" method of computing depletion and pro-

[1] February 8, 1917, 19 Treasury Decisions 31, see Appendix, p. 62.

[2] That part of this Treasury Decision which denied depletion deductions to lessees was overruled in *Lynch* v. *Alworth Stephens Co.*, 267 U. S. 364.

[3] Approved January 2, 1918. Appendix, p. 70.

vided for an alternative method (although not authorized by the statute) where a reasonable estimate of probable resources seemed possible.[1] These regulations also stressed the statutory provision that after the aggregate allowances equalled the investment or 1913 value no further allowances should be made,[2] going on to say:

"The essence of this provision of law is that the owner or operator of this character of properties shall secure through an aggregate of annual depletion deductions, the return of the amount of capital actually invested, or an amount not in excess of the fair market value as of March 1, 1913, of the properties owned prior to that date."

So it is observed that the Treasury Department, up to 1918 in any event, consistently recognized that it was the intent of Congress to permit a taxpayer, through deductions for depletion, to recover tax free the full amount of his investment, or the value at March 1, 1913 of his property, but no more.

This constitutes the background of the Revenue Act of 1918—the departmental interpretation in the light of which that Act was passed. And it is to that background, and to departmental construction contemporaneous with the enactment, that one should look in determining the Congressional intent, rather than to subsequent regulations inconsistent therewith.

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[1] Art. 170, Appendix, p. 71-2.
[2] Art. 170, Second Paragraph, Appendix, p. 70.

## II

**The legislative intent of the Revenue Act of 1918 is indicated by the fact that its provisions with respect to depletion allowances were more liberal than the prior statutes**

In the Revenue Act of 1918, Congress abandoned the provision *requiring* depletion of oil wells to be computed according to "reduction in flow" and left the question of the *method* of computation open for decision by the Department or the Courts. But it became even more liberal than in the Revenue Act of 1916, and provided[1] for depletion on the basis of "discovery value" in cases of exploration subsequent to March 1, 1913—permitting taxpayers, in such cases, to exclude from taxable income an aggregate in excess of the amount of their actual investment.

Certainly this liberality negatives any presumption of a legislative intent in the 1918 Act to be *less* liberal than under the Act of 1916. Similarly, the even more liberal provisions of the Revenue Acts of 1926[2] and 1928,[3] allowing depletion deductions by reference to percentages of gross income from the property, with a *minimum* based upon cost or 1913 value, can hardly be interpreted as legislative constructions of the 1918 Act rendering it less liberal than that of 1916.

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[1] § 234 (a) (9). Appendix, p. 43.
[2] § 204 (c) (2).
[3] § 114 (b) (3).

## III

### The contemporaneous construction of the Revenue Act of 1918 by the Treasury Department sustains the taxpayer's position

The Revenue Act of 1918 was considered by Congress for many months and finally enacted on February 24, 1919. That the Treasury Department was in close touch with the form of the bill and undoubtedly had much to say about its phraseology, can hardly be doubted. It is certain, however, that on the day after the bill became law, the Treasury released the preliminary edition of Regulations 45. Article 203[1] did not provide that the basic value of a lease should be reduced by depletion actually sustained whether legally allowable or not, *but for "deductions for depletion which have or should have been taken to date."* By this it clearly appears that the Treasury believed that the adjustment should be for the amounts which were properly deductible under the prior Revenue Acts. The reasonableness of this construction is demonstrated by the fact that it was carried directly into the statute in the Revenue Acts of 1924, 1926 and 1928.[2]

The preliminary edition was revised and enlarged by Treasury Decision 2831[3] under date of April 16, 1919, which was published as the permanent edition (1919) of Regulations 45.[4] In this revised edition, Article 203 provided for the adjustment of the basis

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[1] Appendix, p. 45.
[2] See pp. 39-40, below.
[3] 21 Treasury Decisions 170.
[4] Appendix, p. 45.

for "deductions for depletion which *has* or should have been taken to date," the only change from the preliminary edition being to substitute "has" for "have". This Treasury Decision, which, if a proper construction of the statute, had the force and effect of law, remained unchanged until December 30, 1920, when it was amended by Treasury Decision 3107,[1] where the regulations took the form in which they are now relied upon by the Government.[2]

## IV

## The decision in United States v. Ludey is controlling in the present case

### A. THE PARALLEL BETWEEN PROVISIONS FOR COMPUTATION OF GAIN OR LOSS AND FOR DEPLETION ALLOWANCES

As shown above, the thought underlying the statutory provisions for depletion deductions was to avoid the inequity of taxing as income the capital value existing at March 1, 1913, or the capital invested after that date. It was similar to the thought that upon the sale of property, not the entire receipts, but only the *gain*—the difference between sale price and cost (or 1913 value) should be treated as income.[3] The two thoughts are necessarily parallel, for in final analysis, the deduction of "depreciation" or "depletion" is in effect the subtraction from sale price of the cost of assets sold piecemeal.[4]

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[1] 22 Treasury Decisions 556.
[2] Appendix, p. 48.
[3] cf. *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179.
[4] *United States* v. *Ludey*, 274 U. S. 295, discussed in detail below.

Accordingly, it is not surprising to find that the Revenue Act of 1918 made similar provisions for determining the base for computing gain or loss on sale, and the base for computing depletion. Section 202 (a) provided:

"That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

"(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

"(2) In the case of property acquired on or after that date, the cost thereof * * *."

Section 214 (a) (10) (applying to individuals) and Section ~~230~~ 234 (a) (9) (corporations) provided for the deduction in computing net income of:

"In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: * * *."

The theory of reducing sale price by cost to determine taxable gain probably seemed too obvious to require elucidation in the regulations, but with respect to depletion the Treasury Department con-

tinued the explanation that had appeared in earlier regulations, saying in Article 201 of Regulations 45:[1]

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions (see article 222), but not including land values for purposes other than the extraction of minerals."

"The limitations prescribed" refer to cost, the value at March 1, 1913, or the value within thirty days after discovery, indicated in Section 214 (a) (10) which is printed in Regulations 45 immediately before Article 201. There are no other "limitations" prescribed in that section nor in the Act.

It is submitted that this is a fair construction of the statute, and that Article 203 of Regulations 45, as subsequently amended on December 30, 1920, is inconsistent therewith, and an erroneous interpretation of the Act.

A striking example of the casuistry of the Government's argument appears on pp. 21–22 of its brief. After repeating that part of Article 201 quoted above, the brief continues:

"The capital value which Article 201 contemplates being returned to the taxpayer by annual depletion

[1] 1920 edition. The phraseology of the preliminary edition (Feb. 25, 1919) and the regular 1919 edition (April 16, 1919) was slightly different, but the substance was the same. See Appendix, p. 44-46.

and depreciation deductions is, quite clearly, we think, the *capital remaining when the 1918 Act became effective.*"

But the Government did not complete the quotation of Article 201, which also provided:

"When used in these articles of the regulations covering depletion and depreciation—

"(a) The term 'basic date' indicates the date of valuation, i.e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913, or the date of discovery, or within 30 days thereafter, in the case of discovery."

### B. THE PARALLEL REGULATIONS INTERPRETING THE PARALLEL STATUTORY PROVISIONS

The 1920 edition of Regulations 45[1] contained two parallel interpretations of the parallel sections of the Act, quoted above. They dealt with adjustments to be made to the basis for determining gain or loss and to the basis for determining depletion, respectively. They were consistent with each other, as were the statutory provisions they interpreted, and if one of them was erroneous, so, necessarily, was the other.

Article 1561 provided:

"For the purpose of ascertaining the gain or loss from the sale * * * the basis is (a) its fair market price or value as of March 1, 1913, if acquired prior

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[1] Published January 28, 1921, but embodying the change effected in Art. 203 by Treasury Decision 3107 on December 30, 1920.

thereto, or, (b), if acquired on or after that date its cost or its approved inventory value. *In both cases proper adjustment must be made for any depreciation or depletion SUSTAINED.*" (Emphasis supplied)

The pertinent part of Article 203 reads:

"(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but *minus (3) depletion and depreciation SUSTAINED*, whether legally allowable or not, from the basic date to the taxable year * * *." (Emphasis supplied)

### C. TREATMENT BY THIS COURT OF ONE SIDE OF THE PARALLEL

The intent of the statute (Section 202 (a)) and the propriety of the regulation (Art. 1561), covering gain or loss on sale, were considered by this Court in *United States* v. *Ludey*.[1]

Ludey had sold an oil well. In computing his gain he had taken the difference between cost and sale price, without any adjustment to cost for depreciation or depletion occurring during his ownership. The Treasury Department, relying on Article 1561 (1920 edition) and on *Appeal of Even Realty Company*,[2] contended that as he had operated the well and sold the oil produced, he had been recovering, in the sale price of each barrel, a part of the cost of his investment in machinery, development ex-

[1] 274 U. S. 295.
[2] 1 B. T. A. 355, 359.

pense, and oil underground; and that having thus recovered it (exempt from tax to the extent of the allowable deductions for depreciation and depletion) he should not be permitted to recover it over again upon the sale of the well. This argument was upheld by the Court which said with respect to the depreciation:[1]

"The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold."

and:[2]

"When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction for the loss of the same capital assets."

That the same is equally true of a capital asset consisting of natural resources, or a leasehold interest, is obvious. And this Court specifically so held saying:

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[1] 274 U. S. at pp. 300-1.
[2] id., p. 301.

"The reasons urged for refusing to apply the rule specifically to oil mining properties seem to us unsound."

And later:[1]

"The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks."

Citing *Lynch* v. *Alworth Stephens Co.*, the court added:

"In essence the deduction for depletion does not differ from the deductions for depreciation."

Thus, *at the instance of the Government*, this Court settled beyond peradventure the proposition that when a taxpayer exhausts the oil from a well, *he is selling his capital piecemeal, and recovering his cost tax free, ratably as he sells it.* It is obvious that, the statutory provisions as to the basis being similar, the same adjustments should be made to the common basis, whether the sale be in one parcel or piecemeal. It would be wholly illogical to say that if the sale is in one parcel, the capital to be recovered is one amount, but if it be piecemeal a different amount should be recovered.

**This brings us to the question of the correct amount by which the basis should be adjusted.**

The Treasury Department urged that the words "proper adjustment must be made for any deprecia-

[1] 274 U. S. at p. 303.

tion sustained" in Article 1561 meant something different from making adjustment for depreciation and depletion allowable as deductions under the earlier Revenue Acts. Although the Revenue Act of 1913 had been enacted in the light of regulations providing for computing depletion by reference to "reduction in flow" and had been enforced by the application of the same and similar regulations, with the five per cent limitation added, the Department claimed that the depletion "sustained" was something different.[1] The effect of the Treasury's proposition is to require adjustment of cost (or 1913 value) for items of depletion attributed to 1913, 1914 and 1915, which items were not deductible under the Revenue Act of 1913; *the very method of ascertaining them having been unrecognized while that Act was in force.*

Having satisfied the Court in the *Ludey* case that, upon the sale of his oil well, the taxpayer should make adjustment to cost for depletion which had occurred during his operation, the Government addressed itself to the *quantum* of that deduction. It urged that the cost should be adjusted for depletion during the taxpayer's operation, including "sustained depletion" for 1913, 1914 and 1915, rather than for the depletion which the taxpayer had been permitted to recover, tax free, during those years.

[1] The cost or March 1, 1913 value of the well is divided by the estimated quantity of oil in reserve at acquisition or March 1, 1913, giving a unit cost to each barrel of oil in the ground. This unit cost is multiplied by the number of barrels extracted in each year to find "sustained" depletion.

But it recognized the weakness of its claim, and asked, in the alternative, for an adjustment in the amount of the depletion *allowable* under the Revenue Act of 1913 for those years.

The Court adopted this alternative, saying:[1]

"We cannot accept the Government's contention that the full amount of depreciation and depletion sustained, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. **Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years.**"

### D. PROPER TREATMENT OF THE OTHER SIDE OF THE PARALLEL

The statutory definitions of the bases for computing gain or loss and for computing depletion being the same, and Articles 1561 and 203 of Regulations 45 (1920 edition) making similar provisions for adjustment to these bases for depletion, the same treatment should be accorded to both articles. This Court held, in effect, that Article 1561 must be modified to provide for adjustment for *allowable* instead of "*sustained*" depletion. Article 203 should be similarly modified.

The Government now urges[2] that the present case differs from *United States* v. *Ludey* in that there the question was with respect to gain or loss upon a *sale*, while here we are dealing with depletion deductions during continued operation. But it should be borne

[1] 274 U. S. at p. 304.

[2] Brief, p. 16.

in mind that this Court, in the same *Ludey* case, upheld the Government's contention that the reason for making the adjustment to cost was that in operating the well and claiming depletion, the taxpayer was *selling* his capital piecemeal. If *past* depletion is a series of sales of parts of invested capital, *future* depletion is equally a series of similar sales. The basis for computing recoverable capital should be the same whether the asset is sold in one parcel, in ten, or in a thousand.

## V

## The inequity of the Government's position

According to the stipulated figures, the taxpayer had on hand at January 1, 1918 an estimated reserve of 326,627 barrels[1] of oil. The 1913 value of $156,645[2] increased by $30,000 cost of addition in 1916, and adjusted for depletion *allowable*[3] for the years 1913–1917 was $160,050.90.

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[1] Findings, R. 10:

| | | |
|---|---|---|
| Estimated oil reserve 3/1/13 | | 278,000 bbl. |
| Added 1916 | | 300,000 |
| | | 578,000 |
| Production 1913–1915—162,717 bbl. | | |
| 1916 | — 49,452 | |
| 1917 | — 39,204 | 251,373 |
| Balance of estimated reserve 1/1/18 | | 326,627 bbl. |

[2] Findings, R. 10.

[3] Depletion allowable under 5% limitation for 1913–1915 (see B.T.A. opinion, R. 11) $ 6,322.02

Sustained depletion 1916 (Findings, R. 10) 11,307.69*

" " 1917 " " " 8,964.39*

$26,594.10

* The taxpayer raised no question as to whether the allowable depletion for 1916 and 1917 differed from sustained depletion, and accepted the Department's figures for the adjustment to be made for those years. cf. footnote p. 4 of Government's brief.

The taxpayer claims that subsequent depletion deductions should be computed upon this base.

The Treasury Department says that adjustment should be for "sustained" depletion of $111,958.23[1] instead of allowable depletion of $26,594.10, leaving $74,686.77[2] at January 1, 1918 to be recovered by subsequent depletion deductions, and a difference of $85,364.13[3] to be recovered, under the *Ludey* decision, when the taxpayer eventually sells the property or abandons operation of the wells. It will pay higher taxes during operation, and have a large loss to claim in the year of abandonment, when it will probably have no income against which the deduction for loss can be applied. The inequity of such

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[1] Findings R. 10

| | |
|---|---|
| "Sustained" depletion 1913–1915 | $ 91,686.15 |
| " " 1916 | 11,307.69 |
| " " 1917 | 8,964.39 |
| | $111,958.23 |

[2] Findings R. 10

| | |
|---|---|
| March 1, 1913 value | $156,645.00 |
| Additions at cost, 1916 | 30,000.00 |
| | 186,645.00 |
| "Sustained" depletion 1913–1917 | 111,958.23 |
| | $ 74,686.77 |

[3] Balance of capital at 1/1/18 not recovered by depletion allowances (of this the taxpayer claims all is recoverable through subsequent depletion allowances) $160,050.90
Treasury says recovery limited to 74,686.77

Difference, to be recovered at eventual sale or abandonment $ 85,364.13

Note that this is the same as the difference between "sustained" depletion 1913–1915 $ 91,686.15
and "allowable" depletion 1913–1915 6,322.02
$ 85,364.13

treatment was conceded in the Government's brief in the *Ludey* case[1] in the following statement:

"indeed it is more equitable and just that the taxpayer should be allowed to replace his capital as it is expended than to require him to wait until the capital asset has entirely disappeared before any recoupment is allowed."

The practice of the Bureau of Internal Revenue with respect to fixing rates for depreciation and depletion, in cases not involving adjustment for depletion in 1913–1915, is well settled. At acquisition the life of a machine or building, or the recoverable content of a mine or oil well, is estimated as accurately as possible. Allowances for exhaustion are based upon this estimate. If, subsequently, the estimate is proven erroneous, a new estimate is made, and the unrecovered cost is spread over the balance of the life of the property. The Bureau refuses to go back and readjust the taxes for prior years in the light of subsequent events.

Thus if a mine cost $10,000 and is estimated to contain 100,000 tons of recoverable coal, the Commissioner will allow depletion at ten cents a ton. If after 50,000 tons of coal have been recovered and $5,000 deducted for depletion, it is discovered that there are really only 25,000 tons left, he will allow the balance of cost, $5,000, to be spread over the balance of coal, 25,000 tons, and allow depletion at twenty cents a ton. If the new estimate should

[1] Point III, p. 21.

show that the original one was low, and that there are still 100,000 tons of coal recoverable, the depletion rate would be reduced to five cents a ton.[1]

In this the Commissioner has been sustained by the Board of Tax Appeals[2] and the Courts.[3]

In the *Kehota Mining Company* case the District Court said:

"The taxpayer is entitled to recover, by way of depletion, the cost of his property. A part of this cost has already been allowed to him in a computation based on the estimated quantity of mineral products in the property. On the making of a new or corrected estimate, thereafter the annual depletion allowance will be computed on the basis of the new estimate, and allowed to the taxpayer, until the entire cost of the property has been recovered by way of depletion allowances. There can be no misunderstanding of the language of the regulation. The new estimate is only to be used in determining the allowances to be distributed annually to the *capital remaining to be recovered.*"

The Circuit Court of Appeals affirmed without discussion, referring to the opinion below. And this Court refused certiorari.

The taxpayer is entitled to spread the cost of his property over the number of units to be extracted. If he correctly estimates the quantity but fails, of his own negligence, to take deductions for allowable

[1] A.R.R. 431, 5 C.B. p. 193.

[2] *Stouts Mountain Coal Co.*, 4 B.T.A. 1292; *Sterling Coal Co. Ltd.*, 8 B.T.A. 549; *Phila. Quartz Co.*, 13 B.T.A. 1146; *Staub Coal Co.*, 16 B.T.A. 584.

[3] *Kehota Mining Co.* v. *Lewellyn*, 28 Fed. (2d) 995, 30 Fed. (2d) 817, cert. denied 279 U. S. 864.

depletion, he cannot make up for his omission by taking additional deductions in subsequent years. But if he has made an honest mistake, he is allowed to spread the recoverable balance of his cost over the balance of the minerals to be extracted. He does not lose the right to recover his capital. In the *Ludey* case, this Court held that he did not lose the right to recover his capital by reason of the limitation in the 1913 Act but could get it back upon a sale of the property. That the same balance should be recoverable if the sale is in instalments is only just. And, under the *Kehota* case, the Board cases, and the Commissioner's own regulations, the proper way to recover the recoverable balance when the property is operated, rather than sold in one parcel, is by depletion—spreading the balance to be recovered over the remaining minerals to be extracted.

## VI

### The departmental interpretation relied on by the Government is not such as to be entitled to any weight as indicative of legislative intent

Of course it is true, as stated on page 12 of the Government's brief, that a departmental regulation will have the force and effect of law *"if not unreasonable or inconsistent with the statute."* This Court held in the *Ludey* case that Article 1561 of Regulation 45 was unreasonable, and we submit that the parallel provisions of Article 203 are equally unreasonable.

If the article should be considered, as the Government's brief claims on page 126—"not as an inter-

pretation of the law but as a supplement to it"—then it is submitted the Treasury Department is usurping legislative functions.

*Contemporaneous* departmental construction, if reasonable, is entitled to considerable weight as indicative of legislative intent. The Treasury Department was in contact with Congress during the many months that the Revenue Act of 1918 was under consideration. It was so well conversant with what was going on in Congress that it had Regulations 45 all ready to promulgate as soon as the statute might be passed. And the preliminary edition of Regulations 45 was published on February 25, 1919, before the Revenue Act was twenty-four hours old.

In that preliminary edition and in the revised and enlarged edition of Regulations 45, approved April 16, 1919,[1] the language of Article 203[2] was in no way ambiguous and clearly provided that the adjustment to cost or 1913 value for prior depletion should be for the depletion which *had or should have been taken to date.* This could only have meant the depletion which should have been taken in accordance with the laws in force for the years referred to. The use of the word "taken" indicates clearly that the intention was to require adjustment for depletion, computed by reference to prior statutes, which should have been deducted on tax returns—not some figures which might have been set up on books for the purpose of determining what the depletion allowance might

[1] T.D. 2381, 21 Treasury Decisions 170–222.

[2] See p. 21, supra; also Appendix, p. 45.

have been had the statutes been different. Only on December 30, 1920, after the contemporaneous departmental construction had continued for almost two years was this regulation altered to the form in which it is now relied upon by the Government.[1]

Of course departmental construction, long continued and generally acquiesced in, has very great weight in the interpretation of statutes. But in *Iselin* v. *United States*,[2] this Court held that an interpretation seven years old was not "long continued" and was not comparable to the forty-year old constructions in *National Lead Company* v. *United States*.[3] Although the regulation relied upon by the Government, was promulgated on December 30, 1920, we have been unable to discover any instance in which it was actually applied, in such a final determination as to render it litigable, prior to the determination in this very case (November 14, 1925). It is well known, among those who practice before the Treasury Department, that, when in 1919 the statute dropped the requirement that depletion be computed by "reduction in flow" and the Treasury Department began to insist that depletion could be computed in every case by reference to reserves of oil underground, which it claimed could be estimated by the study of production rates and pressures over a series of years, the first thing that was done was to prepare a form known as "Form O", on which tax-

[1] T.D. 3107, 22 Treasury Decisions 556–557.
[2] 270 U.S. 245, 251.
[3] 252 U.S. 140.

payers were required to return detailed information with respect to oil wells from the date of their discovery. The collection of data under Form O, the compilation of comparative statistics based upon such data, and the attempt to determine quantities of oil in the secret recesses of the earth took several years. As each new year's returns came in, the Department found it desirable to correct the computations for prior years in the light of the new information, and was not actually closing any substantial oil producers' cases for 1918 and subsequent years, until 1925. Consequently, taxpayers were not in a position to challenge the validity of Article 203 of Regulations 45 (1920 edition) in the courts, because the only processes by which the question could be litigated required, as a necessary preliminary, the determination or assessment of a tax by the Commissioner of Internal Revenue.

This taxpayer's 1918 tax was not finally determined by the Commissioner until November 14, 1925 and immediately (January 4, 1926) the taxpayer commenced this litigation.

When the courts have spoken of long continued departmental construction, they have meant departmental construction which had continued through many years during which it would have been possible to test its validity, judicially. In the instant case, the regulation, dated December 30, 1920, was applied to the taxpayer on November 14, 1925—less than five years later, during which period it seems that no one else had had a fair opportunity to test its validity.

The Government relies[1] on the proposition that Congress "has reenacted in each successive Revenue Act, in substantially the same language, the provision of the Revenue Act of 1918 herein involved" and relies on this as legislative approval of the regulations. The sections of the subsequent Revenue Acts cited by the Government, it is true, are like the section considered in the 1918 Act, in general terms providing for reasonable allowances but not indicating the base upon which they shall be computed or the method of computation. The Government overlooks, however, that in other sections of the Revenue Acts of 1924, 1926 and 1928, Congress specifically covers the question of what the base should be and how it should be adjusted. Section 204 (c) of the Revenue Act of 1924 provides:[2]

"The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property" [with exceptions not here pertinent].

Subdivision (b) thus referred to, provides:

"The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property * * * [exception not here pertinent] or (B) the fair market value of such property as of March 1, 1913, whichever is greater."

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[1] Brief, p. 13.

[2] Appendix, p. 75.

And Section 202 (a) of the same Act provides for the computation of gain or loss as being the difference between the basis provided in Section 204 and the amount realized.

But Section 202 (b) provides:

"In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, *previously allowed* with respect to such property."

So, it is apparent that under the 1924 law, Congress intended the basis for depletion to be adjusted, not for "sustained depletion" of prior years, but for "allowed depletion."

The same is true of the Revenue Acts of 1926[1] and 1928,[2] except that instead of adjustment for depreciation "previously allowed," the adjustment is for depletion, etc., "which have since the acquisition of the property been *allowable* in respect of such property under this Act or prior income tax laws." If there was ever a case of legislative overruling of departmental constructions, it appears in the Revenue Acts of 1924, 1926 and 1928. And the continued repetition in Articles 203 of Regulations 65 and 69, and 222 of Regulations 74, of the require-

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[1] §§ 204 (c), 204 (b), and 202 (b). Appendix, p. 75-6.
[2] §§ 114 (b) (1), 113 (b), and 111 (b). Appendix, p. 76-7.

ment that the base be adjusted for "depletion and depreciation sustained whether legally allowable or not," is as nearly a direct defiance of the statutes as one could hope to find.

## VII

### Every argument advanced on behalf of the Government in this case was presented and necessarily rejected in United States v. Ludey

A comparison of the Government's brief in this case with that filed by it in *United States* v. *Ludey* shows the same arguments in both. In both the generality of the statutory provisions was stressed, and claim made that the Treasury Department had power, in effect, to legislate as to how the depletable base should be adjusted. In both the departmental regulations were said to have been ratified by re-enactment of the interpreted sections of the statute. In both we find the same argument with respect to the alleged necessity for adjustment of the basis by "sustained depletion" for 1913–1915 rather than by depletion "allowable" for those years in accordance with the revenue law then applicable. The Government's position in the *Ludey* case was rejected by this Court. The Court held that adjustment should be made only for "allowable" depletion for prior years. A similar ruling is sought by the taxpayer in this case.

## CONCLUSION

**The judgment of the Circuit Court of Appeals should be affirmed.**

Respectfully submitted,

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March 10, 1931

REVENUE ACT OF 1918 (approved February 24, 1919):

"SEC. 214. (a) That in computing net income [of individuals] there shall be allowed as deductions:

* * * * * * * *

"(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

"SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * * *

"(9) [The language of this subdivision is identical with that of subdivision (10) of Sec. 214 (a), above]."

REGULATIONS 45 (1919 permanent edition) TREASURY DECISION 2831, (21 Treasury Decisions 170, 221, 222) approved April 16, 1919:

"ART. 201. Depletion of mines, oil and gas wells.—A reasonable deduction from gross income for the depletion of natural deposits and for the depreciation of improvements is permitted, based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or, (c) upon the fair market value within 30 days after the date of discovery in the case of mines, oil and gas wells discovered by the taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost. The essence of this provision is that the owner of such property, whether it be a leasehold or freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to the fair market value as of March 1, 1913, of the properties owned prior to that date, or an amount equal to the fair market value within 30 days after the date of discovery of mines, oil or gas wells discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost; plus in any case the subsequent cost of plant and equipment (less salvage value) and underground and overground development, which is not chargeable to current operating expense, but not including land values for purposes other than the extraction of minerals. Operating owners, lessors and lessees are

entitled to deduct an allowance for depletion, but a stockholder in a mining or oil or gas corporation is not. See further articles 839 and 844. [Articles 839 and 844 deal with invested capital]."

"ART. 203. Capital recoverable through depletion allowance in the case of lessee.—In the case of a lessee the capital remaining in any year recoverable through depletion allowances is the sum of (a) the cost of the leasehold, or its fair market value as of March 1, 1913, or its fair market value within 30 days after discovery, as the case may be, plus (b) the cost of subsequent improvements and development not charged to current operating expenses, but minus (c) deductions for depletion which *has* or should have been taken to date and (d) the portion of the capital account, if any, as to which depreciation has been and is being deducted instead of depletion. Any annual or periodical rents or royalties supplementing the bonus or other amount paid for the lease may be charged to current operating expenses or, *until the property reaches the operating stage*, to capital account, and in the latter event will form part of the capital returnable through deductions for depletion."

REGULATIONS 45 (Preliminary edition, released February 25, 1919):

"ART. 201. [This was the same as in the permanent edition, quoted above]."

"ART. 203. [This was the same as in the permanent edition, quoted above, except that the word 'have' appeared in place of the word 'has' italicized, and the italicized words 'until the property reaches the operating stage' did not appear]."

REGULATIONS 45 (1920 edition, promulgated January 28, 1921):

"ART. 201. Depletion of mines, oil and gas wells; depreciation of improvements.—Sections 214 (a) (10) and 234 (a) (9) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. The provisions of the statute and these articles do not apply to or affect the regulations covering invested capital, losses, accounting methods, etc.

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (a) his capital invested in the property, or (b) the value of his property on the basic date, plus subsequent allowable capital additions (see article 222), but not including land values for purposes other than the extraction of minerals.

"Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a stockholder in a mining or oil or gas corporation is not allowed such deductions. (See further articles 839 and 844.)

"When used in these *articles* of the regulations covering depletion and depreciation—

"(a) The term 'basic date' indicates the date of valuation, i.e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913,

or the date of discovery, or within 30 days thereafter, in the case of discovery.

"(b) The 'fair market value' of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase. Where there has been no sale and the fair market value at the basic date is to be used, such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving at the sale value of the property at the basic date.

"(c) A 'mineral property' or 'property' is the oil or gas well, including the mineral, plant, development, and surface value of the land. The value of a mineral property is the combined value of its component parts.

"(d) A 'mineral deposit' refers to 'minerals only,' such as the 'ores only' in the case of a mine, to the 'oil only' in the case of an oil well, and to the 'gas only' in the case of a gas well. The value of a mineral deposit is its cost; or it is the value of the mineral property, less the value of the plant, equipment, and surface of the land for purposes other than mineral production.

"(e) 'Minerals' comprise ores of the metals, coal, oil, gas, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand and gravel, silica, slate, soapstone, soda, sulphur, and talc.

"(f) 'Operating profit' is the net income from mineral production before depletion and depreciation are deducted. It is distinct from net income."

"ART. 203. Capital recoverable through depletion deductions in the case of lessee.—(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

"(b) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

"(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is the value of his interest in the mineral as of that date.

"(d) The value of a lessee's equity in a proven mineral property acquired *on or* after March 1, 1913, is its cost.

"(e) The value of a lessee's equity in a discovery on or after March 1, 1913, is the fair market value at date of discovery or within 30 days thereafter, of his equity in the mineral discovered."

The only differences between these articles as they appear in the 1920 edition and as they had been published in Treasury Decision 3107 (December 30, 1920, 22 Treasury Decisions 556), were the substitution of the word "articles" italicized in Art. 201 above, for "sections" in the Treasury Decision, and the insertion of the words "on or" italicized in Art. 203 (d) above, which did not appear in the Treasury Decision.

Corporation Excise Tax Act of 1909 (36 Stat. 113, 118, approved August 5, 1909:

"Chapter 7. Sec. 38 * * * (second) such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * *

"Second. * * * (second) all losses actually sustained within the year and not compensated by insurance or otherwise including a reasonable allowance for the depreciation of property, if any * * *."

REGULATIONS 31. (December 3, 1909):

"Article 4.—Deductions. * * *

"Depreciation.—The deduction for depreciation should be the estimated amount of the loss, accrued during the year to which the return relates, in the value of the property in respect of which such deduction is claimed that arises from exhaustion, wear and tear, or obsolescence out of the uses to which the property is put, and which loss has not been made good by payments for ordinary maintenance and repairs deducted under the heading of expenses of maintenance and operation or in the ascertainment of gross income. This estimate should be formed upon the assumed life of the property, its cost value, and its use. Expenses paid in any one year in making good exhaustion, wear and tear, or obsolescence in respect of which any deduction for depreciation is claimed must not be included in the deduction for expense of maintenance and operation of the property or in the ascertainment of gross income, but must be made out of accumulative allowances deducted for depreciation in current and previous years."

TREASURY DECISION 1606 (approved March 29, 1910, 13 Treasury Decisions 39):

"Depreciation

"71. Where increase or decrease during the year in the value of real estate acquired in previous years, sold or held for sale, cannot be accurately determined, such increase or decrease may be prorated, as provided by regulations in cases of sale of capital assets.

"72. Depreciation in value of mines by the removal of ore, if not otherwise ascertainable, may be prorated as in the case of sales of capital assets.

"73. Depreciation in value of mines by the removal of ore, if in excess of 5 per cent of investment, to be explained in return rendered.

"74. Estimated depreciation in oil or gas wells, buildings, machinery, etc., to be stated in detail, if exceeding 5 per cent of value as previously inventoried.

"75. Corporations leasing mines and paying royalties on ore mined not entitled to deduction for depreciation. But corporations owning mines are entitled to allowances for depreciation based on fair estimate, etc.

"76. Removal of timber from timber lands, while depleting the lands to the extent of such removal, is regarded as a change in the form of assets and not a depreciation within the meaning of the act.

"77. Deduction on account of depreciation of property must be based on lifetime of property, its cost, value, and use.

"78. Voluntary removal of buildings, etc., for purpose of improvements not regarded as loss or depreciation, and no deduction therefor should be made.

"79. Depreciation of company's stock a loss to the stockholders, but not a loss to the company issuing the same, and therefore not a proper deduction."

TREASURY DECISION 1675 (February 11, 1911, 14 Treasury Decisions 16):

"The following synopsis of decisions made, from time to time, on questions relating to the special excise tax imposed by section 38, act of August 5, 1909, on corporations, joint-stock companies, associations, and insurance companies, is published for the information of internal-revenue officers and others concerned.

* * * * * * * *

"Depreciation.

* * * * * * * *

"72. Cost of drilling new wells by oil corporations is considered betterments and additions to the capital assets of the corporation. The expense of drilling dry wells may, however, be charged to profit and loss.

* * * * * * * *

"Depreciation in Minerals, Oils, Etc.

"80. In case of corporations whose business consists in part or wholly of mining, producing, and disposing of deposits of nature (ores, coals, gas, petroleum, and sundry minerals) the conduct of such business will be understood to comprehend two classes of gains or losses, viz:

"(a) The gain or loss resulting from the sale of capital assets, i.e., either the increment, or the loss, arising through possessing over a period of time the investment in the same.

"(b) The trading or commercial gain attached to the conduct of the industry, the employment of working capital, the effort and risk involved.

"81. In the ascertainment of net income deduction will be allowed for depreciation arising from exhaustion of deposits of ore, mineral, etc., and for depreciation and obsolescence of improvements, in accordance with general regulations respecting depreciation allowances, on the basis of the original capital investment cost of the properties concerned to the company reporting.

"82. A further deduction will also be allowed, through not including the same at all in the item of gross income (item 3, Form 637), for the unearned increment represented in such properties as at January 1, 1909, which will be determined in general as follows:

"83. An estimate should be made as of January 1, 1909, of the fair market value at that date of the minerals, etc., in deposit. This estimate should be formed on the basis of the disposal value of the minerals *in total* and exclusive of value of improvements and development work. This valuation should also be reduced to a unit value—per ton, barrel, etc.

"NOTE.—Values as aforesaid should not be estimated on the basis of the assumed salable value of the output under current operative conditions, less the actual cost of production, because, as hereinbefore stated, the selling price under such conditions comprehends a profit both for carrying the investment in minerals, improvements, and working capital, and for conducting operations in respect of production and disposal of product. The value to be determined as stated must be on the basis of the salable

value of the entire deposit of the aggregate units of minerals considered *en bloc* if disposed of in that form. Nor must such valuation comprehend any speculative value which might attach to a sale of the minerals *en bloc*, i.e., a value which might be obtained on the ground that the future would develop a much greater reserve of mineral deposits than were believed to exist at the time estimate as of January 1, 1909, was formed. Any value of this latter character would attach obviously to such additional reserves when developed in future.

"84. The unit value as of January 1, 1909, ascertained as above outlined, would indicate the value to be attached at that date to the capital assets disposed of during any calendar year succeeding, and should be used in determining the unearned increment at January 1, 1909, which may be excluded entirely from the item of gross income, as before explained, in following manner, viz:

| | | |
|---|---|---|
| Value at January 1, 1909, determined in manner outlined, of minerals, etc., which may be removed and disposed of in any year subsequent thereto..... | | $——— |
| Less the following: | | |
| (a) Proportion of depreciation charge applying to exhaustion of minerals disposed of, ascertained as first explained herein on basis of original cost..... | $——— | |
| (b) Royalty paid, if any, on minerals disposed of..... | ——— | ——— |
| Balance, being unearned increment at January 1, 1909, to be excluded from gross-income item..... | | ——— |

"85. The precise detailed manner in which the estimate of value of minerals, etc., as at January 1, 1909, shall be formed, must naturally be determined upon by each corporation interested, but formal record of such estimates, together with all sustaining information, should be carefully filed so as to be readily accessible for reference. Values as stated, as determined at January 1, 1909, should be used in compilation in all subsequent years' excise-tax returns. The question as to whether it subsequently develops the property possessed a greater quantity of mineral, etc., reserve than was in the aggregate estimated as of January 1, 1909, is immaterial. Any excess which may be developed will be considered as possessing the same value at January 1, 1909, as that which then may have been known to be in the property.

"86. Each excise-tax return (Form 637) should be accompanied with memorandum setting forth the extent in amount of the exclusion made from the item gross income for unearned increment realized during the year, as above outlined.

"87. As the amount to be deducted for depreciation (paragraph 2 preceding) is to be formed on basis of the estimated reserve of minerals, etc., it follows that if it develops such estimate is understated, the cost investment in the capital asset may be wholly extinguished before all mineral reserves are removed. When this is reached, further deductions for exhaustion of minerals should be discontinued but in such event, it will be noted, the allowance for unearned increment which is to be excluded entirely from gross income will be correspondingly increased.

"88. In case of corporations leasing mines and paying royalties on minerals, etc., removed, the

royalties paid are to be treated as expenses and deducted in ascertaining net income, as provided in general regulations. Any leasehold investment which the operating corporation may have in such properties, either through a payment originally made for acquirement thereof or for improvements made upon the property, to be accounted for in accordance with regulations governing depreciation allowances and disposition of capital assets.

"89. In respect to properties of the character in question which may be acquired by a corporation after January 1, 1909, a deduction will be allowed only as to depreciation arising from exhaustion based on original cost; no exclusion from gross income can be made for unearned increment, as profit arising in sale of such capital assets applies wholly to the period subsequent to January 1, 1909."

TREASURY DECISION 1755 (January 22, 1912, 15 Treasury Decisions 12):

"Item 80 of T. D. 1675 is hereby amended by striking out the parenthetical word 'petroleum,' and the following regulation to govern the rate of return of capital invested on the basis of the rate of depletion of oil-producing properties in making return of annual net income for the special excise tax on corporations is issued in lieu thereof:

"1. In the case of corporations whose business consists of producing and disposing of crude petroleum, the conduct of such business will be understood to comprehend two classes of gains or losses, viz: (a) The gain or loss resulting from the sale of capital assets—i. e., either the increment or the loss arising through possessing over a period of time the investment in the same. (b) The trading or commercial

gain attached to the conduct of the industry, the employment of working capital, and the effort and risk involved.

"2. In the ascertainment of net income, deduction will be allowed for depreciation arising from exhaustion of deposits and for depreciation and obsolescence of improvements in accordance with the general regulations respecting depreciation allowances, on the basis of the original capital-investment cost, reduced to a cash basis, of the properties concerned to the company reporting. Claims for depreciation on account of depletion of deposits based on any values other than the cost of the property in cash or cash values (including cost of development) will not be considered.

"3. In all producing oil fields an average value per barrel of the settled daily production shall be adopted as the guide in determining the value of the property, and the following method in depreciating said values is recommended:

"Each corporation will fix this valuation per barrel as of January 1, 1909, or upon the date of commencement of production, if after that date, for ascertaining the deductions for depreciation on the basis of depletion of deposits. This valuation per barrel should be based on the cost of the property to the corporation, plus the cost of the development thereof with a proper deduction from that valuation for the number of years the property has been in operation, and the resulting proportioned decrease in daily production of oil. With this basis per barrel fixed as of January 1, 1909, or at the date of commencement of production, if after January 1, 1909, the value of the property as a whole is to be determined by applying this unit value per barrel to the daily average production for the month

of December, or other representative month, in the year for which the return is made. The representative month chosen shall be the same in each year. This unit valuation per barrel is to be retained in arriving at all future depreciation deductions, except where an additional production is secured by drilling or an additional production is acquired by purchases, in which cases a new average rate per barrel based upon the actual cash invested in such development, or in the new properties and their development, may be adopted. The amount of income each year to be applied to the return of the cash investment shall be ascertained by multiplying the unit valuation ascertained as required above by the difference between the daily average production in barrels during the representative month of each year. The product of such multiplication will be the amount deductible from gross income on account of return of cash investment based upon the rate of depletion of deposits.

"4. The cost of drilling and equipping new producing wells shall be considered additions to capital investment account; the expense of drilling dry holes may be charged to profit and loss.

"5. The amount of petroleum produced and sold during the year or the price received for the same will not, so far as the application of this regulation to determine depreciation is concerned, affect the value of the property at the end of the year, which value is based only on the comparative rate of decrease in production in accordance with the standard unit value ascertained as stated above.

"6. Each excise tax return should be accompanied with a memorandum showing how the standard unit valuation was arrived at, i. e., the valuation of the producing property as of January 1, 1909, or at the

commencement of development, if after that date, and such additional investment in development as may have been made during the year, together with the daily average yield for each month of the year, or for each month since the commencement of operation, if subsequent to January 1, 1909.

"7. Where properties are operated upon lease, the cost of the leasehold interest, plus the cost of development, shall be the basis for determining the unit valuation for the purpose of providing for the deduction from gross income of the returnable cash investment.

"8. All depreciation deductions from the net income return must be evidenced by proper entries on the books of the corporation reporting, so as to show a reduction in the capital assets equal to the cash investment returned, as provided above, out of gross income.

"NOTE.—It will be apparent that by following the plan suggested, the value of the producing property appearing in the capital assets of the company will be automatically and wholly extinguished coincident with the complete exhaustion of the product, with the exception of such salvage as may remain after said exhaustion."

REVENUE ACT OF 1913 (approved October 3, 1913, 38 Stat. 166–81):

"SEC. 2. G. * * *

"(b) Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint-stock company or association, or insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation

of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any; and in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per centum of the gross value at the mine of the output for the year for which the computation is made; * * * ."

REGULATIONS 33 (approved January 5, 1914):

"ART. 130. The depreciation allowance, to be deductible, must be, as nearly as possible, the measure of the loss due to wear and tear, exhaustion, and obsolescence, and should be so entered on the books as to constitute a liability against the assets of the company, and must be reflected in the annual balance sheet of the company. The annual allowance deductible on this account should be such an amount as that the aggregate of the annual allowances deducted during the life of the property, with respect to which it is claimed, will not, when the property is worn out, exhausted, or obsolete, exceed its original cost.

"ART. 139. Corporations owning tracts of timber lands and removing therefrom and selling, or otherwise disposing of the timber will be permitted to deduct from their gross income on account of depreciation or depletion an amount representing the original cost of such timber, plus any carrying charges that may have been capitalized or not deducted from income. The purpose of the depreciation or depletion deduction is to secure to the corporation, when the timber has been exhausted, an aggregate amount

which, plus the salvage value of the land, will equal the capital actually invested in such timber and land.

"ART. 140. When an amount sufficient to return this capital has been secured through annual depreciation deductions no further deduction on this account shall be allowed. For the purpose of increasing the deduction on this account no arbitrary increase in values shall be made, unless such increase in value shall be returned as income for the year in which the increase in value was taken up on the books.

"ART. 141. The depreciation of coal, iron, oil, gas, and all other natural deposits must be based upon the actual cost of the properties containing such deposits. In no case shall the annual deduction on this account exceed 5 per cent of the gross value at the mine (well, etc.) of the output for the year for which the computation is made.

"ART. 142. The term 'gross value at the mine,' as used in paragraphs B and G of section 2 of the act of October 3, 1913, prescribing a limit to the amount which may be deducted in the return of individuals and corporations as depreciation in the case of mines, is held to mean the market value of ore, coal, crude oil, and gas at the mine or well, where such value is established by actual sales at the mine or well; and in case the market value of the product of the mine or well is established at some place other than at the mine or well, or on the basis of the bullion or metallic value of the ore, then the gross value at the mine is held to be the value of the ore, coal, oil, or gas sold, or of the metal produced, less transportation, reduction, and smelting charges.

"If the rate of 5 per cent per annum shall return to the corporation its capital investment prior to the ex-

haustion of the deposits, the rate on which the annual deduction for depletion of deposits is based must be lowered in accordance with the estimated number of years it will take to exhaust the estimated reserves.

"In case the reserves shall be in excess of the estimates, no further deduction on account of depletion shall be made where the capital investment has been returned to the corporation.

"ART. 143. In addition to the deduction to measure the loss due to depletion, the corporation will be allowed the usual depreciation of its machinery, equipment, etc., such depreciation to be determined on the basis of the cost and estimated life of the property with respect to which the depreciation is claimed.

"ART. 144. Corporations leasing oil or gas territory shall base their depletion deduction upon the cost of the lease, and not upon the estimated value, in place, of the oil or gas."

REVENUE ACT OF 1916 (approved September 8, 1916, 39 Stat. 756–77):

"SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

"(a) For the purpose of the tax there shall be allowed as deductions—

* * * * * * * * *

"Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation

are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided*, That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. * * *"

"SEC. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

* * * * * * * *

"Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; (a) [balance indentical with Sec. 5 (a) Eighth, above]."

TREASURY DECISION 2447 (February 8, 1917, 19 Treasury Decisions 31):

"Section 5, deduction 'eighth,' and section 12, deduction 'second,' of Title I, act of September 8, 1916, authorize individuals and corporations owning and operating gas or oil producing properties to make deductions from gross income on account of depletion as follows:

"In the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production, to

be ascertained not by the flush flow but by the settled production or regular flow, provided that when the allowance authorized shall equal the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made.

"The purpose of this provision is to afford a means whereby the individual or corporation owning oil or gas producing properties may, during the period of operation, deduct from gross income the cost of, or capital actually invested in, the natural deposits if the investment was made subsequent to March 1, 1913, or the fair market value as of March 1, 1913, if purchased prior to that date, the measure of the deduction being the reduction in the flow and production.

"The annual deduction authorized by the above-quoted provision must be reasonable and not in excess of such a percentage of the cost or value, as the case may be and as herein defined, of the oil or gas producing properties as is indicated by the reduction in the original flow or settled production of one year as compared with that of the preceding year.

"For the purpose of this deduction note may be taken of the reduction in flow and production of such individual wells as were producing oil or gas during or at some time within the year of groups of wells or of all wells in the field or territory embraced in the same ownership. If tested by the aggregate flow of all of the wells in the field or territory owned by an individual or corporation and new wells shall have been developed during the year, it is possible that at the end of the year there will have been no reduction in flow and production, in which case, under the specific provision of the law hereinbefore quoted and under which the depletion deduction is measured by the

reduction in flow and production, there can be no deduction for depletion.

"Hence, in the case of a field or territory in course of development or in which new wells are being drilled, if the depletion deduction is to be availed of in the returns of annual net income each individual well or possibly each group of wells in operation at the beginning of, or brought in, during the year, if the flow and production of the group of wells is so assembled as to be tested must be tested at the end of the year in order that the decline in the flow and production may be determined.

"New wells or new groups of wells brought in during the year may be tested as soon as they have reached the stage of settled production or regular flow, and then again at the end of the year. The decline in flow and production, if any, as indicated by these tests will be reduced to a percentage basis and a like percentage of the capital invested in the oil or gas property (exclusive of machinery, equipment, etc.) will constitute an allowable deduction from the gross income of the year on account of depletion. Thus, if the decline in the flow and production during the year of, say, 10 wells, costing $100,000, has been 5 per cent, as compared with the production and flow as indicated by a test made at the beginning of the period, then 5 per cent of $100,000, or $5,000, will, for the year for which the computation is made, constitute an allowable depletion deduction in favor of the individual or corporation owning and operating the property.

"If the wells are not so situated that their flow and production may be assembled in order to test and ascertain the reduction in the output as a basis for computing depletion, it will be necessary for the cor-

poration or individual owning the property and claiming a depletion deduction to take an accurate gauge of the production and flow of each well at a certain same period of each year, and by comparing this gauge with that of the previous year determine the percentage by which the production and flow has been reduced. This having been done as to all of the wells in operation, an average percentage rate of reduction in flow and production will be ascertained and this rate will be applied to the capital invested; that is, the value of the oil or gas property as of March 1, 1913, or the cost of the same if acquired subsequent to that date, for the purpose of determining the amount which may be allowably deducted from gross income by such owning individual or corporation on account of depletion.

"In case of a field or territory fully developed and in which no new wells are being drilled, a comparison of the quantity of oil or gas produced during the year for which the computation is made with the quantity produced during the last preceding year, will disclose the reduction, and the percentage thus indicated of the reduction in flow and production of such field will be the measure of the depletion deduction to be taken by the owner with respect to the capital invested in such field.

"Notwithstanding the fact that the drilling of new wells may offset the reduction in the production and flow of the older wells in the field not fully developed, the provision of the law hereinbefore quoted does not authorize, and this office can not permit, a depletion deduction to be taken so long as the flow and production of the unit, be it a well or group of wells or the entire territory, is as great during the year for which

the return is made as it was for the year immediately preceding.

"Illustrating in a general way the above rule as applied to a field or territory the case may be taken of an oil property in which the capital invested, either actual cost or fair market value, as the case may be, is $500,000 and the production during the year for which the return is made was 47,500 barrels, and for the year immediately preceding 50,000 barrels. This would indicate a reduction in production of 2,500 barrels, or a decline of 5 per cent. Applying this rate to the capital ($500,000) the individual or corporation owning the property would be entitled to deduct from gross income as depletion for the year for which the return is made the sum of $25,000, that is, 5 per cent of the invested capital.

"The depletion deduction in all cases until the capital invested is extinguished will be such a percentage of the unextinguished capital as the reduction in flow or production of one year is a percentage of the flow or production of the previous year.

"The estimate of the fair market value of gas and oil properties as of March 1, 1913, on which depletion deductions are based shall be the price at which the property as an entirety might have been sold for cash or its equivalent as of that date. The value hereinbefore contemplated must naturally be determined by each individual or corporation interested and who is the owner of the property upon such basis as will not comprehend any operating profits, the estimated value in all cases to be subject to the approval of the Commissioner of Internal Revenue.

"Every individual or corporation entitled to a deduction for depletion on account of reduction in flow

or production of oil or gas shall keep an accurate ledger account, in which shall be charged the fair market value as of March 1, 1913, or the cost, if the property was acquired subsequent to that date, of the property whose value declines with the removal of the natural deposits. This account shall be credited with the amount of the depletion deduction claimed and allowed each year, to the end that when the credits to the account equal the debits, no further deduction for depletion with respect to this property and the capital invested in it will be allowed.

"The value determined and set up as of March 1, 1913, or the cost of the property if acquired subsequent to that date, will be the basis for determining the depletion deduction for all subsequent years during the ownership under which the value was fixed, and during such ownership there can be no revaluation for the purpose of this deduction if it should be found that the estimated quantity of oil or gas contained in the property was understated at the time the value was fixed or at the time the property was acquired.

"The provision of the law authorizing the depletion deduction, designed as it is to provide a means whereby the invested capital of an individual or corporation may not be subject to the tax imposed by this title, does not apply to individuals or corporations who are operating oil or gas properties under lease, since in those cases the operator has no capital invested in such properties. By capital invested, as herein used, is meant the fair market value of the properties as of March 1, 1913, if acquired prior to that date, or their actual cost if acquired subsequent to that date, as it relates to the owner in fee of the properties.

"Lessees will, however, be permitted to deduct from gross income each year a reasonable allowance for depreciation, which depreciation applies to the physical property, including rigs, tools, machinery of all kinds, pipes, casing, and other equipment necessary to the operation of the wells or field. If lessees, in order to secure the right to enter upon, explore, develop, or operate gas or oil properties, paid or shall pay a bonus in addition to royalties the amount of such bonus so paid may be ratably distributed over the life of the lease or over the productive life of the property, and the lessee may deduct annually as a rental payment an aliquot part of the amount of the bonus so paid until such amount has been extinguished.

"The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense. If, in exercising the option, the operating individual or company charges the expense of drilling wells to property account, the same may be taken into account in determining a reasonable allowance for depreciation during each year until the property account thus augmented has been extinguished through annual depreciation deductions, after which no further deduction on this account will be permitted. The cost of drilling dry or nonproductive wells may be deducted from gross income as a loss.

"To each return made by an individual or corporation owning and operating oil or gas properties there

should be attached a statement showing (1) (a) the fair market value of the property (exclusive of machinery, equipment, etc.) as of March 1, 1913, if acquired prior to that date, or (b) the actual cost of the property if acquired subsequent to that date; (2) how the fair market value of the property as of March 1, 1913, was ascertained; (3) the quantity of oil or gas produced during the year for which the return was made; (4) the quantity produced during the year immediately preceding; (5) how the depletion deduction claimed in the return was computed, whether upon the decline in flow and production of individual wells, groups of wells, or the entire field; and (6) any other data which would be helpful in determining the reasonableness of the depletion deduction claimed in the return.

"If the operator is a lessee that fact should be stated and an explanation given as to the basis and property upon which any depreciation deduction is claimed, it being understood, as hereinbefore indicated, that depreciation relates to the loss due to the use, wear, and tear of physical property, and that the lessee is not entitled to any deduction for the depletion or exhaustion of the oil or gas deposits, but may deduct annually as a rental payment an aliquot part of any bonus paid for the right to enter upon, explore, develop, and operate oil or gas territory, as well as the royalty payments made to the lessor for the oil or gas removed from such property, provided the entire proceeds from the oil or gas produced during the year are returned in the gross income of the operator.

"The above rule for computing allowable depletion deductions being set out in the law, no deduction on this account will be allowed if computed upon any

basis other than that authorized by the law and further amplified in this decision."

REGULATIONS 33, REVISED (approved October 3, 1917):

"ART. 170. Sections 5 and 12 of the act of September 8, 1916, as amended by the act of October 3, 1917, authorize individuals and corporations owning and operating gas or oil properties, to deduct from gross income—

"'A reasonable allowance * * * for actual reduction in flow and production, * * * provided that when the allowance authorized * * * shall equal the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made.'

"The essence of this provision of law is that the owner or operator of this character of properties shall secure through an aggregate of annual depletion deductions, the return of the amount of capital actually invested, or an amount not in excess of the fair market value as of March 1, 1913, of the properties owned prior to that date.

"For the purpose of determining the amount of capital to be returned through annual deductions, operators may be divided into two classes, (a) operators who own the fee, and (b) operators who own a lease or leases.

"In the case of the operating fee owner, the amount returnable through depletion deductions is the fair market value of the property (exclusive of the cost of physical property) as of March 1, 1913, if acquired prior to that date, or the actual cost of the property if acquired subsequent to that date, plus, in either

case, the cost of development (other than the cost of physical property incident to such development) up to the point at which the income from the developed territory equals or exceeds the deductible expenses.

"In the case of a lessee, the capital thus to be returned is the amount paid in cash or its equivalent as a bonus or otherwise by the lessee for the lease, plus also all expenses incurred in developing the property (exclusive of physical property) prior to the receipt of income therefrom sufficient to meet all deductible expenses, after which time as to both owner and lessee, such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the drilling of wells and further development of the property, may, at the option of the operator, be deducted as an operating expense or charged to capital account.

"If, in exercising this option, the individual or corporation charges the expense of drilling wells or further development to capital account, the same, in so far as such expense is represented by physical property, may be taken into account in determining a reasonable allowance for depreciation during each year until the property account thus augmented has been extinguished through annual depreciation deductions, after which no further deduction on this account will be allowed. In the case of a going or producing business, the cost of drilling nonproductive wells may be deducted from gross income as an operating expense.

"ESTIMATE OF PROBABLE RESOURCES.

"In the case of either an owner or lessee it will be required that an estimate, subject to the approval of the Commissioner of Internal Revenue, shall be made

of the probable quantity of oil or gas contained in or to be recovered from the territory with respect to which the investment is made. The invested capital (value as of Mar. 1, 1913, or cost, if acquired subsequent to that date, plus the cost of development, other than cost of physical property, up to the point of expense-paying production, in the case of an owner, and the amount actually paid for the lease plus cost of development, other than cost of physical property, up to the same point, in the case of a lessee) will be divided by the number of units of oil or gas so estimated to be contained in or to be recovered from the territory, and the quotient will be the per unit cost or amount of capital invested in each unit recoverable. This quotient, or per unit cost, when multiplied by the number of units removed from the territory during any one year, will determine the amount which may be allowably deducted from the gross income of that year on account of depletion of assets or as a return of invested capital until the total of such deductions shall equal the capital invested.

"Every individual or corporation entitled to a deduction on account of the depletion of the property under operation or for a return of the capital invested with respect to the same shall keep an accurate ledger account, in which, in the case of fee owner, shall be charged the fair market value as of March 1, 1913, or the cost, if acquired subsequent to that date, of the oil or gas property, plus cost of development as hereinbefore defined, or, in the case of a lessee, the amount actually originally invested in the case and its development. This account shall be credited with the amount claimed and allowed each year as a deduction on account of depletion or as a return of capital, to the end that when the credits to the account equal

the debits no further deduction on either account, with respect to this property and the capital invested therein, will be allowed. Or, in lieu of a direct credit to property account, the amount so claimed and allowed as a deduction may be credited to a depletion reserve account.

"WHERE RESOURCES ARE UNCERTAIN.

"If for any reason the quantity of oil or gas in the property can not be determined with any degree of certainty, the depletion deduction will be computed in accordance with the rule set out in Treasury Decision 2447, except that lessees may compute their deduction for return of capital (cost of lease and development) in the same manner as owners in fee; that is, they may extinguish such capital on the basis of the reduction in flow and production as compared with the preceding year, or, in the case of leasehold properties brought in or developed during the year, the depletion deduction may be computed on the basis of the decline in settled flow and production, as evidenced by tests and gauges made at the end of the year as compared with similar tests and gauges made at the time the settled flow was determined.

"For the purpose of computing the depletion the territory comprehended in a given lease will be considered the unit with respect to which the depletion deduction may be claimed and allowed.

"If the operator is the owner of the fee the value determined and set up as of March 1, 1913, or the cost of the property if acquired subsequent to that date, or, if the operator is a lessee, the amount actually paid for the lease, plus, in the case of both owner and lessee, the cost of subsequent development, exclusive of physical property, if such cost is

capitalized, will be the basis for determining the depletion deduction or the deduction for return of capital for all subsequent years during the continuance of the ownership under which the value was fixed or by which the investment was made, and during such ownership there can be no revaluation for the purpose of this deduction if it should be found that the quantity of oil or gas in the property was underestimated at the time the value was fixed or the property was acquired, or at the time the lease contract was entered into or purchased.

"This rule will not, however, be so construed as to forbid an operator from redistributing the invested capital over the estimated number of units remaining in the territory under operation if a subsequent increase of invested capital should render this necessary in order to determine the amount of such capital applicable to each unit, provided that when such redistribution is made the total capital invested will be reduced by the amount previously charged off and deducted on account of depletion or as a return of capital."

REVENUE ACT OF 1924 (approved June 2, 1924):

"SEC. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

"(b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or deple-

tion, previously allowed with respect to such property."

"SEC. 204. * * * * * * * * * * *

"(b) The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property (or, in the case of such property as is described in paragraph (1), (4), or (5), of subdivision (a), the basis as therein provided), or (B) the fair market value of such property as of March 1, 1913, whichever is greater. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

"(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except [the exceptions deals with discovery subsequent to February 28, 1913]."

REVENUE ACT OF 1926 (approved February 26, 1926):

"SEC. 202. (a) [Identical with Sec. 202 (a) of the Revenue Act of 1924, above].

"(b) In computing the amount of gain or loss under subdivision (a)—

"(1) Proper adjustment shall be made for any expenditure or item of loss properly chargeable to capital account, and

"(2) The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, ob-

solescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws; but in no case shall the amount of the diminution in respect of depletion exceed a depletion deduction computed without reference to discovery value or to paragraph (2) of subdivision (c) of section 204. In addition, if the property was acquired before March 1, 1913, the basis (if other than the fair market value as of March 1, 1913) shall be diminished in the amount of exhaustion, wear and tear, obsolescence, and depletion actually sustained before such date.

"SEC. 204. * * * *

"(b) [Identical with Sec. 204 (b) of the Revenue Act of 1924, above]."

"(c) [Identical with Sec. 204 (c) of the Revenue Act of 1924, as far as quoted above but makes additional provisions for discovery values and for depletion allowance based on 27½% of gross income]."

REVENUE ACT OF 1928 (approved May 29, 1928):

"SEC. 111. (a) [Identical with Sec. 202 (a) of the Revenue Act of 1924, above].

"(b) [Identical with Sec. 202 (b) of the Revenue Act of 1926, above, except for a cross reference to percentage depletion not found in the 1926 Act]."

"SEC. 113. * * *

"(b) [Identical with Sec. 204 (b) of the Revenue Act of 1924, above, except for use of numbers instead of letters to indicate categories, and reference to 'subdivisions' instead of to 'paragraphs'.

"SEC. 114. * * *

"(b) Basis for depletion.—

(1) General rule.—The basis upon which depletion is to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property, except as provided in paragraphs (2) and (3) of this subsection."

# SUPREME COURT OF THE UNITED STATES.

No. 288.—October Term, 1930.

David Burnet, Commissioner of Internal Revenue, Petitioner, *vs.* Thompson Oil & Gas Company. } On Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit.

[April 13, 1931.]

Mr. Justice Roberts delivered the opinion of the Court.

The Commissioner of Internal Revenue determined a deficiency in the respondent's income tax for 1918. Upon the taxpayer's petition the Board of Tax Appeals sustained the Commissioner.[1] An appeal was taken to the Court of Appeals, which reversed the judgment of the Board.[2] This court granted certiorari.[3]

The question presented is whether under § 234 (a) (9) of the Revenue Act of 1918[4], in determining for any taxable year the capital value, recoverable through depletion allowance, of oil mining properties acquired prior to March 1, 1913, there should be deducted from the March 1, 1913 value of the properties the amount of depletion actually sustained in earlier years, or only so much of such depletion as was allowable as deductions under the revenue acts in force in those years.

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[1] 15 B. T. A. 993.

[2] 40 F. (2d) 493.

[3] 282 U. S. —.

[4] 40 Stat. 1077. Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . (9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of costs up to that date: . . . such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. . . .

The Board of Tax Appeals found the following facts. The taxpayer owned an oil and gas mining lease acquired prior to March 1, 1913. On that date the recoverable oil in the reserve embraced by the lease was 278,000 barrels, and its value was $156,645, or $0.56347 per barrel. Between March 1, 1913 and December 31, 1915, it extracted 162,717 barrels of oil, so that at the unit rate mentioned it sustained depletion amounting to $91,686.15. Its deduction for depletion in computing net income under the Revenue Act of 1913[5] was computed not by reference to the number of barrels extracted, or to the value of the reserve on March 1, 1913, but by taking five per cent. of the gross income from the sale of oil. The depletion allowance for 1913 to 1915, inclusive, computed by this method, amounted to $6322.02.

In 1916 the taxpayer secured an extension of its lease at a cost of $30,000, whereby its oil reserve was increased by 300,000 barrels. There then remained of the original reserve 115,283 barrels having a value as of March 1, 1913, of $64,958.85. The Commissioner added to this depleted value the cost of the extension of the lease, and added to the remaining oil reserves of the original lease the additional 300,000 barrels then acquired. He thus ascertained a new total recoverable reserve of 415,283 barrels having a basic value or cost of $94,958.85, or $0.22866 per barrel. There were no subsequent additions to the reserves.

In 1916 there were produced under the lease 49,452 barrels of oil, and in 1917, 39,204 barrels, leaving the reserve at January 1, 1918, 326,627 barrels.

A new method of allowance for depletion was adopted in the Revenue Act of 1916[6]. Depletion was sustained under the formula

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[5] c. 16, § II. B.; 38 Stat. 167. That in computing net income . . . there shall be allowed as deductions: . . . sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, . . .

[6] c. 463, 39 Stat. 767-768. Sec. 12 (a). In the case of a corporation . . . such net income shall be ascertained by deducting from the gross amount of its income . . . Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including . . . (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; . . .

therein prescribed in those two years, amounting to $20,272.08. It is agreed that this figure is correct and represents the sustained depletion as well as allowed depletion for those years.

During 1918 there were produced 33,697 barrels of oil. At the unit price adopted by the Commissioner of $0.22866 per barrel, the depletion sustained and allowed for that year was $7705.16. It is this depletion allowance for the year 1918 which is here called in question.

In view of the fact that the depletion actually sustained by the taxpayer between March 1, 1913 and December 31, 1915, was $91,686.15, whereas in conformity with the act of 1913 the deduction actually allowed it as for depletion was only $6322.02, the respondent contended that the unit rate of depletion per barrel for 1918 should have been based upon the original March 1, 1913 value of the reserves, plus the cost of the extension of the lease, and less only that portion of the actually sustained depletion which was in fact allowed pursuant to the terms of the 1913 act. The Commissioner, on the other hand, subtracted from the March 1, 1913, value plus the cost of the extension of the lease, the sustained or actual depletion, holding that the entire depletion actually sustained should be deducted from the original March 1, 1913 value, regardless of whether it was allowable as deductions from the gross income of the years 1913, 1914 and 1915. The Circuit Court of Appeals decided in favor of the respondent.

The parties agree that respondent is not entitled as matter of right to make any deduction from annual income for depletion of the oil extracted and sold during the year. If it may take any such deduction, authority therefor must be found in the statute.[1] It follows that the question for decision is purely one of statutory construction.

It is clear that Congress intended that the lessee of an oil well should be entitled to a reasonable allowance for depletion based upon cost or March 1, 1913 value. It did not however attempt to prescribe a formula for ascertaining it, but expressly delegated that function to the Commissioner of Internal Revenue, who was to make rules and regulations to that end. Pursuant to this authority, regulations were made, which required the deduction of depletion theretofore sustained in ascertaining the capital remaining in any

[1] *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103; 60 L. Ed. 546.

year recoverable by depletion deductions.[8] It is undisputed that the Commissioner calculated the depletion deduction in this case in accordance with the regulations.

The taxpayer contends, however, and the court below held, that the allowance granted was not reasonable—as the act required it should be—because although it reflected the actual depletion in the year 1918, considered by itself, the result of the application of the regulation will fall short of returning to the taxpayer its March 1, 1913, capital tax-free at the date of exhaustion of the oil reserve. It is said that this was the intent of Congress as shown not only by the terms of the act, but by the history of prior legislation. Hence it is claimed that only the depletion allowed under the act of 1913 should be deducted in ascertaining the depletable capital at January 1, 1918. Thus respondent would recover its entire capital tax-free. The Government contends that the depletion allowance provided by the regulations is reasonable.

It is evident that the act of 1913 did not allow enough to return the capital on exhaustion of the reserve. The deduction permitted by that act fell some $85,000 short of what was required in 1913-1915 for that purpose. Was it then the intent of the act of 1918 to permit a deduction from gross income for depletion which would represent not only that year's sustained depletion, but make up for sustained but disallowed depletion in the earlier years? The Government says, and we think rightly, that there is nothing in the terms of the act to indicate any such purpose. The tax is an income tax for 1918, and in the absence of express provision to the contrary, it is not to be supposed that the taxpayer is authorized to deduct from that year's income, depreciation, depletion, business losses or other similar items attributable to other years.[9] The very

[8] Art. 203. Capital recoverable through depletion deductions in the case of lessee.—(a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year. . . .

[9] As to losses, see *De Loss* v. *Commissioner*, 28 F. (2d) 803; *Burns* v. *Commissioner*, 31 F. (2d) 390. Compare *Newman* v. *Commissioner*, 41 F. (2d) 743.

fact that Congress denied deductions equal to the sustained depletion in the earlier years negatives an intent that they should be allowed in later years, as if for depletion then sustained. The construction adopted by the court below in effect results in including in the taxable year items referable to other years, and is contrary to the theory of a tax for specific years.

The nature of the tax as one for annual periods has been repeatedly mentioned in dealing with its application in various situations.[10] The taxable year 1918, and that only, is involved, and deductions applicable to that year only should be allowed.

The court below recognized that its decision resulted in attributing an excessive value to the reserves remaining in 1918, but thought that *United States* v. *Ludey*[11] required it so to hold. That case, however, involved the determination of taxable gain or loss on the sale of an oil property. To ascertain gain on a sale of a capital asset, there must be subtracted from the sale price a sum sufficient to restore the value at the date of acquisition (or March 1, 1913).[12] The remainder is income. So in the *Ludey* case it was held that, in order to ascertain the depleted cost, only the allowed depletion should be deducted from the original cost. Allowed depletion rather than sustained depletion was there the true measure of deduction. But here the question is what allowance Congress intended should be made from the gross annual income of the operation of an oil well. In the one case the question is how much of the capital has already been returned tax-free; in the other how much of the oil reserve remains at the beginning of a taxable year to be depleted over the period remaining until exhaustion. The court below relied on certain statements in the opinion in the *Ludey* case which were applicable in the determination of gain on a sale, but which do not apply in this case, for if the sale of each barrel of oil were a partial sale of the reserve (which it is not) to apply the rule which respondent seeks to deduce from the *Ludey* case would increase the cost or 1913 value of each barrel sold, in determining gain or loss in 1918, beyond its actual cost or 1913 value, solely by reason of the fact that too low a cost or 1913 value was

[10] *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. —; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. —; *Fawcus Machine Co.* v. *United States*, 282 U. S. —.

[11] 274 U. S. 295; 71 L. Ed. 1054.

[12] *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179; 62 L. Ed. 1054.

taken for barrels sold in prior years. The decision in the *Ludey* case has been adopted in the later statutes as affecting sales of capital assets,[13] but the provision for annual depletion allowance has remained substantially unchanged.[14] This in itself is persuasive evidence that Congress has approved the executive construction embodied in the regulations.[15]

Respondent insists that the increasing liberality in the statutory provisions for depletion allowances in the successive Revenue Acts, indicates that Congress never intended that the 1918 act should be so construed or administered as to deprive the taxpayer of the return of his entire capital tax-free. But the increasing liberality was to be applicable in calculating net income for the successive years and we can find no evidence either in the acts or in the regulations, of any intent to increase future depletion allowances to redress the inadequacy of those previously permitted.

It follows that the judgment must be

*Reversed.*

A true copy.

Test:

*Clerk, Supreme Court, U. S.*

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[13]Act of 1924, c. 234, 43 Stat. 253, 283; Act of 1926, c. 27, § 202 (b) (2), 44 Stat. 9, 12; Act of 1928, c. 852, § 111 (b) (2), 45 Stat. 791, 815.

[14]Act of 1921, § 234 (a) (9), 42 Stat. 227, 256; Act of 1924, § 234 (a) (8), 43 Stat. 253, 284; Act of 1926, § 234 (a) (8), 44 Stat. 9, 42; Act of 1928, § 23 (l), 45 Stat. 791, 800.

[15]*United States* v. *Hermanos*, 209 U. S. 337; 52 L. Ed. 821; *National Lead Co.* v. *United States*, 252 U. S. 140; 64 L. Ed. 496.